**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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| Order Instituting Investigation into the ratemaking implications for Pacific Gas and Electric Company (PG&E) pursuant to the Commission's Alternative Plan for Reorganization under Chapter 11 of the Bankruptcy Code for PG&E, in the United States Bankruptcy Court, Northern District of California, San Francisco Division, In re Pacific Gas and Electric Company, Case No. 01-30923 DM. | Investigation 02-04-026 (Filed April 22, 2002) |

# DIRECT TESTIMONY OF PAUL CLANON IN SUPPORT OF THE SETTLEMENT AGREEMENT SPONSORED BY PACIFIC GAS AND ELECTRIC COMPANY (PG&E), PG&E CORPORATION, AND THE PUBLIC UTILITIES COMMISSION (PUC) STAFF

## I. Introduction

The proposed settlement agreement[1] is a fair and reasonable resolution to PG&E's bankruptcy, balancing the cost of paying creditors in full and establishing a financially healthy utility against the ratepayers' need for an integrated PG&E providing service in a stable regulatory environment. There have been no easy choices in the PUC's development of its own Joint Plan of Reorganization for PG&E (sponsored with the Official Committee of Unsecured Creditors (OCC))[2] (PUC/OCC Joint Plan); the PUC/OCC Joint Plan has required rates to be kept higher longer than they otherwise would have been, and the PUC/OCC Joint Plan has faced stiff opposition from PG&E, opposition that threatened to delay PG&E's emergence form bankruptcy. These same considerations should inform the PUC's review of the proposed settlement.

The proposed settlement is a consensual solution to PG&E's bankruptcy based on the framework of the PUC/OCC Joint Plan, with significant environmental enhancements:

- There will be no disaggregation of PG&E into separate companies, most not under State regulation. There will be no regulatory jailbreak.
- PG&E will remain integrated and under State direction.
- Creditors will be paid in full.

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[1] Settlement Agreement sponsored by PG&E, PG&E Corporation and PUC Staff which underlies the Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for PG&E Date June 27, 2003, Proposed by PG&E, PG&E Corporation and OCC. See Exhibit A, attached hereto.

[2] Filed on August 30, 2002 pursuant to Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court, Northern District of California, San Francisco Division (In re Pacific Gas and Electric Company, Case No. 01-30923 DM) as amended on November 6, 2002 and on December 5, 2002.

- PG&E will emerge as a financially healthy utility with the full range of financing options available to build and maintain energy infrastructure.
- The environment will be preserved and enhanced.

PG&E's rates resulting from the proposed settlement's plan must be a prime focus of the PUC's review of the proposed settlement. There is no magic that can protect California from paying for the results of the electricity crisis, and part of that bill must be paid to get PG&E out of bankruptcy. It is in the public interest for the PUC to approve the proposed settlement and help PG&E and its ratepayers turn the corner on the energy crisis.

## II. PG&E Bankruptcy History

PG&E filed for Chapter 11 protection under the Bankruptcy Code of the United States on April 6, 2001 as a solvent debtor. In September 2001, PG&E filed its Plan of Reorganization,[3] proposing to disaggregate PG&E into four separate entities along functional lines and transfer certain assets from PUC regulation to the Federal Energy Regulatory Commission (FERC):

- Generation (under FERC regulation)
- Electric Transmission (under FERC regulation)
- Gas Transmission (under FERC regulation)
- Distribution (under PUC regulation)

After receiving bankruptcy court permission, the PUC proposed an alternative plan of reorganization on April 15, 2002 that would keep PG&E fully integrated. The issuance of $1.75 billion in new common equity to help pay creditors' claims was an element in the PUC's initial plan of reorganization for PG&E. On August 22, 2002, the OCC joined the PUC to become co-proponents of an alternative plan of reorganization, which contemplated the issuance of preferred securities in lieu of common equity. The PUC/OCC Joint Plan was amended on November 6, 2002 and December 5, 2002. On February 2003, PG&E amended its plan of reorganization to satisfy conditions specified in Standard & Poors' (S&P) updated preliminary rating evaluation. Among the modifications was PG&E Corporation's issuance of up to $700 million of equity. In March 2003, the Bankruptcy Court ordered the PUC and PG&E into a judicially-supervised settlement conference, which resulted in the proposed settlement agreement in June of 2003.

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[3] In re Pacific Gas and Electric Company, Case No. 01-30923 DM.

## III. Terms of the Proposed Settlement Agreement

The proposed settlement agreement would:

- Keep PG&E as an integrated utility under the Commission's regulation.
- Resolve all significant legal issues between the Commission and PG&E stemming from the electricity crisis.
- Pay creditors in full in cash (or reinstatements) right away.
- Permit rates to begin falling as early as January 1, 2004. Just as important, the proposed settlement would put PG&E and the PUC back on the path of constructive regulation under state law.

## Terms of the Proposed Settlement Agreement

- PG&E abandons utility disaggregation
- Resolves energy-crisis related litigation
- Creditors paid in full
- Establishes a $2.21 billion regulatory asset amortized "mortgage style" over nine years
- Provides PG&E with $775 to $875 million in headroom revenues in 2003
- Provides certain guarantees on return on equity and capital structure
  - Unamortized Regulatory Asset
    - 52% floor on authorized equity component once PG&E's equity component of capital structure reaches 52%
  - Remaining Capital Structure
    - Until S&P confers a company credit rating of at least "A-" or Moody's confers "A3"
    - ROE floor of 11.22%
    - 52% floor on equity ratio except for a transition period in 2004 and 2005 where the floor is 48.6%
- Restricts dividends
  - No dividends on common stock before July 1, 2004
  - PG&E estimates that shareholders will forego approximately $1.7 billion in dividends from October 2000 to July 2004
- PG&E donates to public agencies or non-profits, or provides conservation easements on, 140,000 acres of land
  - Includes watershed lands associated with hydroelectric facilities
  - Includes the 655-acre Carizzo Plains
  - PG&E establishes a non-profit Environmental Enhancement Corporation to oversee environmental management of the donated lands
  - Governing board will include members from various state agencies, including three to be named by the PUC
  - PG&E will fund the corporation with $70 million over ten years through electric rates
- PG&E establishes a non-profit corporation to support research and investment in clean energy technology
  - Governing board will include members appointed by the PUC
  - PG&E shareholders will bear the cost of funding the corporation with $15 million over five years

## IV. The Settlement Agreement is Fair, Reasonable, and in the Public Interest

The proposed settlement is reasonable and would allow PG&E and its ratepayers to turn the corner on the electricity crisis, with PG&E remaining as one utility under State regulation, with rates beginning to come down, with PG&E's watershed lands dedicated forever to public use, and with PG&E as a financially healthy utility capable of implementing State policy and providing safe and reliable service to its customers. No currently foreseeable path other than a reasonable settlement of PG&E's bankruptcy offers the possibility of these benefits as rapidly, or with as much PUC control over the outcomes.

Since the year 2000, PG&E's ratepayers have been blacked out, price-gouged by certain generators and marketers, and forced to pay high surcharges to keep the lights on. The ratepayers have seen the State forced to issue $11.3 billion in bonds just to pay for a few months' purchases by the Department of Water Resources (DWR), and now face higher rates for twenty years to pay bondholders back. The ratepayers have watched as State government, including the PUC, was forced to take extraordinary action after extraordinary action to try first to slow the hemorrhaging and then to get the electricity industry in California back to some kind of normality. The ratepayers have seen PG&E enter bankruptcy and stay there for two years and counting. The ratepayers have seen the PUC and PG&E battling in courts and at the FERC at a time when the State must decide how the electricity industry should be planned and regulated in the future, how needed power plants and transmission lines will be built, and how the relationship between regulated utilities and the State will be established and maintained.

### A. The Settlement Agreement Eliminates the Risk Posed by PG&E's Disaggregation Plan

PG&E's bankruptcy plan in the absence of a settlement is based on breaking up PG&E's historic utility business into four separate entities: (1) a generation company under FERC regulation and charging contract rates to the utility that are higher than cost-of-service rates over the twelve-year period of the contract (see section below for discussion on rate comparison), and thereafter going to uncontrolled market prices, (2) an electric transmission company that would be solely rate-regulated by the FERC, (3) a FERC-regulated gas transmission utility, in stark contrast to the rest of California's PUC-regulated in-state backbone transmission, and (4) a PUC-regulated distribution utility. Such a disaggregation of PG&E into four distinct parts would bring about operational and execution risks and raise serious questions about the State's continued ability to protect the environment. Ratepayers benefit from a fully integrated utility because it is structurally better able to provide reliable service.

PG&E's disaggregation plan foregoes the protections provided by the California Environmental Quality Act (CEQA). CEQA is the principal law in California requiring comprehensive consideration of environmental impacts. CEQA requires public agencies to consider the environmental impacts of projects under the agency's discretion. PG&E claims that federal law preempts CEQA under its plan, an outcome that would deprive Californians of the historically stringent and protective environmental guidelines provided by CEQA.

The change from traditional rate-of-return regulation, which will continue under the proposed settlement agreement, to the contract-based structure and market-based rates under PG&E's disaggregation plan alters the risk/reward equation for environmental and safety expenditures. Without the ability to recover such costs under market-based rates, decisions to undertake environmental and safety projects may be directly influenced by profitability considerations which may run counter to the environmental protection Californians deserve.

### B. The Settlement Agreement Results in Just and Reasonable Rates

The proposed settlement would allow PG&E's rates to fall immediately by about half a cent per kilowatt-hour[4], and fall further in succeeding years.

#### 1. Projected Rates Under the Settlement Agreement[5]

| | Current | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Bundled Rate (cents/kwh) | **13.87** | **13.36** | **13.32** | **13.16** | **13.18** | **12.92** |

These projected rate reductions can happen even though ratepayers must contribute, via rates, to paying the creditors and getting PG&E back to financial health. Under the proposed settlement, ratepayers will contribute: 1) headroom accumulated primarily through the surcharge rates the PUC adopted in D.01-01-018 and D.01-03-082; and, 2) the cost of the regulatory asset going forward. The settlement agreement provides PG&E, among other things, with a $2.21 billion regulatory asset[6]; under the proposed settlement, the net after-tax amount of any refunds or other credits from generators will be applied to reduce the outstanding balance of the regulatory asset dollar for dollar[7]. PG&E estimates generator refunds of $600 million (pre-tax) if the existing FERC generator refund orders are upheld, plus an additional several hundred million more if the additional natural gas pricing changes in the March 26, 2003 FERC order are fully achieved, plus an amount for refunds from Energy Service Providers, plus an amount for interest savings (which could be as much as $100 million on the generator claims alone). For illustrative purposes, the table below illustrates the

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[4] May change subject to a more refined forecast from PG&E.

[5] Amendment Dated July 7, 2003 Adding to Disclosure Statement For Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for PG&E Dated June 27, 2003, Proposed by PG&E, PG&E Corporation and OCC, Exhibit C, page 12.

[6] Settlement Agreement, Section 2, page 10.

[7] Settlement Agreement, Section 2. d., page 12.

estimated ratepayer contribution to the Settlement Agreement, absent any refunds or other credits from generators.

### 2. Estimated NPV Ratepayer Contribution to Settlement Agreement

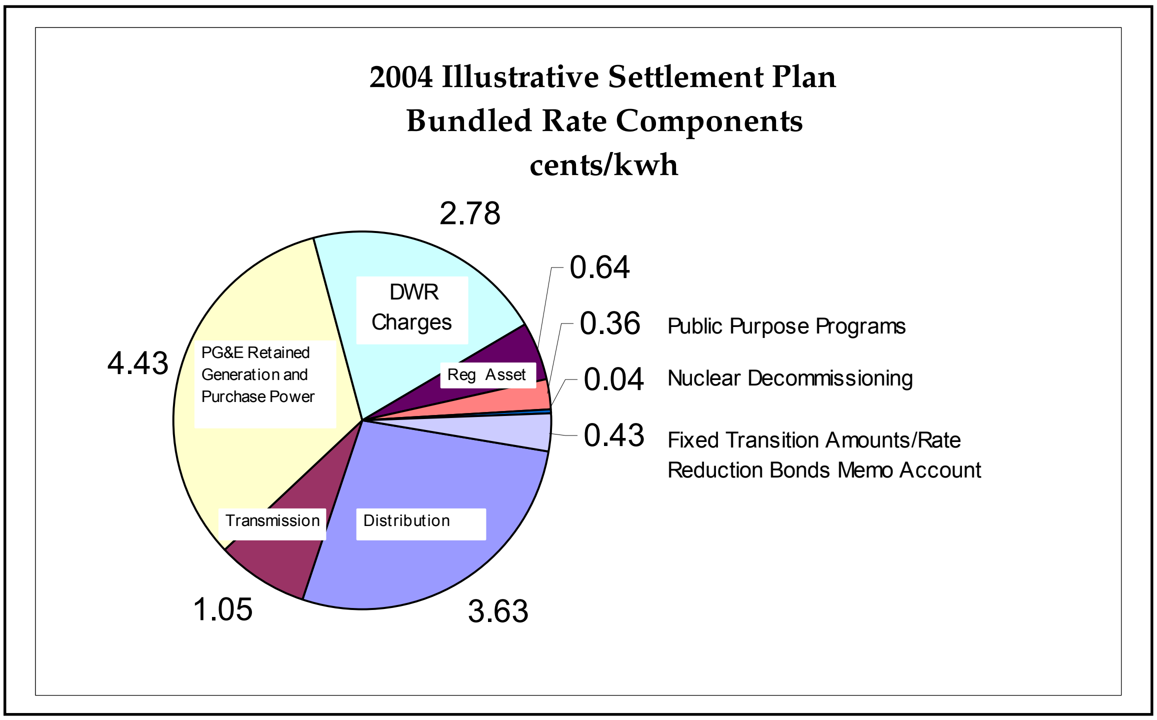
| | In $Millions |
|---|---|
| **2001 and 2002 Pre-Tax Headroom[8]** | **$3,200** |
| **2003 Pre-Tax Headroom[9]** | **$775 to $875** |
| **NPV of the Regulatory Asset[10]** | **$2,210** |
| **NPV of the Tax Component of the Regulatory Asset[11]** | **$944** |
| **Estimated Ratepayer Contribution** | **$7,129 to $7,229** |

PG&E's rates are high, and they would remain high for many years to come even had PG&E never gone into bankruptcy and there were no huge PG&E debts to pay off. This is because the electricity crisis has left investor-owned utility ratepayers saddled with the costs of paying off $11.3 billion in bonds sold to cover the Department of Water Resources' (DWR) costs of keeping the lights on during 2001, and the ongoing high costs of long-term power contracts DWR was forced to enter into in 2001 and which will stay in effect for as long as 10 more years.[12] The PUC at one point estimated the excess costs of these long-term

[8] PG&E reported in its 2002 10-K SEC Report approximately $1.9 billion after-tax headroom for 2001 and 2002. The $3.2 billion represents Energy Division's estimate of the pre-tax equivalent based on a 40.75% tax rate.
[9] In Settlement Agreement, Section 8. b., page17.
[10] In Settlement Agreement, Section 2, page 10.
[11] The tax component is pursuant to Settlement Agreement, Section 2 c., page 11. Net present value is based on a 9% discount rate.
[12] The latest contract expiration is December 31, 2013.

contracts at $14.3 billion over their contract terms[13]. Nothing the Commission can achieve in the resolution of PG&E's bankruptcy can insulate the ratepayers from these extraordinary costs.

The PUC addressed the energy crisis by raising PG&E's rates by an unprecedented 48%, or 4.5 cents per kilowatt-hour between January and May of 2001.[14] In the view of the public, that amount represents the cost of the electricity crisis to ratepayers, and the end of the crisis should bring a reduction of rates to their prior levels. That view is not unreasonable, but because both the DWR bonds and the DWR long-term contracts impose higher costs on ratepayers for many years to come, the time when that 4.5-cent increase can go away is long in the future. These costs far exceed even the significant

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[13] PUC's Section 206 Complaint, Table 1 – 44 CDWR Transactions in Excess of Forward Market Prices, FERC, Docket No. EL0260.

[14] PUC raised rates by 1 cent in Decision (D.) D.01-01-018 and by another 3 cents in D.01-03-082. Because the 3-cent increase was not implemented in rates until May 2001, the PUC adopted an additional half-cent "catch-up" surcharge in D.01-05-064, which remains in effect today.

ratepayer costs contemplated by the proposed settlement agreement. As illustrated above,[15] DWR charges comprise about 2.78 cents of the 13.36 cents per kilowatt-hour bundled rate projected for 2004, dwarfing by comparison the 0.64 cents per kilowatt-hour rate component from the regulatory asset contemplated in the proposed settlement agreement.

Rates under the settlement agreement lie between the rates ratepayers would see under PG&E's disaggregation plan and the PUC/OCC joint plan were either to be implemented. Ratepayers would be served by a financially-sound utility that can meet its obligation to serve under State regulation for less cost than under PG&E's disaggregation plan. Under PG&E's disaggregation plan, the reorganized PG&E would enter into an agreement to purchase power from the new generation company for twelve years.[16] According to PG&E, that power would cost ratepayers 5.19 cents per kilowatt-hour.[17] After the expiration of the 12-year contract, the output from the generating facilities would be sold at market-based rates. Ratepayers would save about $1 billion nominally over 12 years under the settlement agreement compared to PG&E's disaggregation plan.[18]

Under the proposed settlement PG&E's return on equity (ROE) would be reasonable and adequate to attract needed capital without being overly generous at ratepayer expense. The settlement agreement provides that PG&E's ROE:

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[15] Source for data: PG&E.

[16] In the last year of the agreement, a portion of the output from the Diablo Canyon Power Plant and certain of the hydroelectric facilities will no longer be subject to the agreement

[17] Eugene T. Meehan Workpapers Supporting Direct Testimony on behalf of Electric Generation LLC in FERC Docket No. ER02-456.

[18] For illustrative purposes, generation rates inclusive of the costs attributable to the regulatory asset under the settlement agreement results in a 5.07 cent per kilowatt

*Footnote continued on next page*

1. Shall be no less than 11.22% on the regulatory asset
2. Shall be no less than 11.22% on the remaining capital structure until either S&P confers on PG&E a company credit rating of at least "A-" or Moody's at least "A3" [19]

OCC witness Thomas E. Lumsden testifies that the 11.22% ROE provided in the settlement agreement is consistent with the historic authorized return of PG&E and falls within the range of ROEs for comparably- situated utilities. See Testimony of Thomas E. Lumsden. Once PG&E reaches the credit rating mentioned above, the Commission will resume its full discretion to establish PG&E's reasonable ROE.

### C. The Settlement Agreement Pays Creditors in Full and Results in a Creditworthy PG&E

The proposed settlement would pay PG&E's creditors in full using available cash on hand and new and reinstated debt and preferred equity. PG&E would emerge from bankruptcy financially healthy, meeting the rating agencies' objective criteria for investment grade. See Steven M. Fetter Testimony in PG&E's Chapter 6 and Paul J. Murphy Testimony in PG&E's Chapter 7. It is critical for PG&E to meet at least minimum investment-grade ratings so that it can ensure the successful sale of the $7.68 billion debt securities contemplated in the settlement agreement. Paul J. Murphy illustrates in his testimony that a high-yield (non-investment grade) transaction of this size has never been completed in the United States and that there have been no high-yield offerings even approaching the size contemplated in the settlement agreement in the past 10 years. See Paul J. Murphy Testimony in PG&E's Chapter 7.

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generation levelized rate based on an escalation of the revenue requirements adopted by the PUC for utility retained generation. See Appendix B.

[19] Settelement Agreement, Sections 2.b. and 3.b.

### 1. Projected Sources and Uses of Funds at Emergence[20]

| Sources of Funds | (In $Millions) | Uses of Funds | (In $Millions) |
|---|---|---|---|
| Available Cash | $2,365 | Estimated Allowed Claims | $13,700 |
| New Long-Term Debt [21] | $7,681 | Claims paid[22] and other Adjustments | ($1,564) |
| Short-Term Debt | $500 | | |
| Reinstated Debt | $1,160 | | |
| Reinstated Preferred Stock | $430 | | |
| **Total Sources of Funds** | **$12,136** | **Total Uses of Funds** | **$12,136** |

### 2. Ratepayers Benefit from a Creditworthy/Investment-Grade PG&E

PG&E's current senior secured credit rating is "CCC" by S&P and "B3" by Moody's Investor Service (Moody's), and its unsecured credit rating is "D" by S&P and "Caa2" by Moody's -- well into junk status. The initial reaction of the credit rating agencies as a whole to the proposed settlement agreement has been guardedly positive.

Non-investment grade credit ratings are bad for ratepayers because:

- It would be hard for PG&E to borrow money for infrastructure improvements and maintenance, and procurement. The utility has depended many times in the past on access to capital markets in order to keep the lights on. During most of the 1970s and up to 1984 PG&E had significant construction programs for Diablo Canyon,

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[20] Assumes emergence on January 1, 2004. Source for data: PG&E.

[21] Excludes additional unfunded credit facilities totaling $1.9 billion.

[22] Claims paid during bankruptcy pursuant to Court orders.

Helms, and the Geysers that required ready access to the capital markets. PG&E witness Steven Fetter in Chapter 6 testifies that PG&E's financial forecast highlights the fact that the utility business is a capital-intensive industry: over $8 billion of capital expenditures are expected during the next five years. See Steven M. Fetter Testimony in PG&E Chapter 6. A power plant can cost $500 million[23], a transmission line $300 million.[24] In the Procurement Rulemaking (R. 01-10-024), pursuant to Assembly Bill ("AB 57") (Stats. 2002, Chap. 835) and Senate Bill ("SB") 1976 (Stats. 2002, Chap. 850), the PUC is now examining PG&E's short- and long-term plans for building or buying enough generation capacity to meet its load for the next twenty years. During that time PG&E's projects its load to grow by about 40%,[25] which will have to be met by a combination of energy efficiency, demand response, and new generation whether owned by PG&E or under contract. All of these options cost money, and several mean large up-front capital expenditures. PG&E's ability to borrow money, and to obtain lines of credit, will be crucial to the State's ability to ensure that the lights stay on, and that statutory and regulatory policies (for example, the Renewables Portfolio Standard enacted in SB 1078 (Stats. 2002, Chap. 516), as recently implemented by the PUC in D.03-06-071) are

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[23] Based on data from California Energy Commission – Power Plant Projects Recently Approved By Energy Commission, Currently On Line as of July 15, 2003, Projects Greater than 300 MW.

[24] PG&E's total estimated construction cost for the proposed Path 15 project, an 84-mile single 500 kilovolt overhead line, in PG&E's application for Certificate of Public Convenience and Necessity in A.01-04-012.

[25] Estimate provided by Roy Kuga, PG&E Director of Gas and Electric Supply, representing projected load growth from 2004 to 2023.

implemented. The State can set its policies, but a financially weak utility might not be able to carry them out.

- Borrowing that does occur is more expensive for ratepayers. As shown in the testimony of Paul J. Murphy, PG&E's ability to issue investment-grade debt under the settlement plan saves ratepayers over $2.1 billion in interest costs over 10 years compared to sub-investment grade debt (assuming PG&E can successfully sell sub-investment grade securities of the size contemplated in the settlement plan.) See PG&E's Chapter 7.
- The rating agencies and by extension the financial community view all of California with more suspicion when the State's largest regulated utility is considered a bad credit risk.

### D. The Settlement Agreement Resolves Outstanding Legal Issues Between the Commission and PG&E

Adopting the proposed settlement avoids significant ratepayer risk in several venues.

#### 1. Bankruptcy Court.

PG&E's proposed plan, were it to be implemented, would expose the ratepayers and the people of California to economic damage, risks to public safety and the reliability of electricity and natural gas service, the possibility of harm to the environment, and perhaps most important of all the permanent reduction of State influence and control over the future of PG&E as a public utility. Ratepayers and the people of California would lose not just in present and foreseeable ways, but in future and unforeseeable ways as well – California's voice in PG&E's future would be quieted. In Bankruptcy Court, the PUC has itself made the case for the danger to ratepayers and the people of California should PG&E's proposed plan be implemented. As the PUC stated in its December 9, 2002 Trial Brief in the Bankruptcy Court:

- “There Could Be Significant Harmful Effects to Public Safety, Welfare, and the Environment if PG&E’s Plan is Implemented” (12-9-02 Trial Brief, page 9)
- “PG&E’s Plan Abrogates California’s Ability to Determine Whether PG&E Can Meet Its “Duty to Serve” and Other Statutory Duties Under California Law” (ibid, pg10)
- “The PG&E Plan Generates Economic Incentives for Environmental Harm and Proposes to Preempt the Application of State Law that Could Check Any Such Harm” (ibid, pg 11)
- “The PG&E Plan Seeks to Preempt State Law Designed to Assure Reliable and Sufficient Natural Gas Service for California Citizens” (ibid, 13)

The Commission has also told the Court that PG&E’s proposal for the disaggregated distribution utility to buy power from the new generation affiliate under a FERC-regulated Power Sales Agreement (PSA) would have the ratepayers buying power from PG&E’s affiliate at prices higher than ordinary regulated rates for the twelve-year life of the PSA. After that, things could get worse – PG&E’s plan would have its generation affiliate selling power at uncontrolled “market-based” prices.

PG&E’s plan to have ratepayers buy this power back at high prices from PG&E’s generation affiliate isn’t just a theoretical concern or a worry based on uncertain forecasts. The power plants in question were under the PUC’s regulation until they were sold post-AB 1890, and the PUC knows well how much their reasonable costs are. As stated previously, ratepayers would pay about $1 billion more nominally over twelve years for the power under the PSA than under regulated rates under the proposed settlement agreement.

### 2. Federal District Court – The "Filed Rate Doctrine" Case

The proposed settlement would dismiss PG&E's lawsuit against the PUC related to PG&E's claim that the PUC unlawfully prevented PG&E from passing on wholesale power costs to ratepayers during the height of the electricity crisis in 2000-2001. Although the PUC vigorously opposes PG&E's arguments in that case, the results of litigation are always uncertain, and should PG&E prevail, PG&E's claims in the case amount to approximately $9 billion. See PG&E v. Lynch, Complaint.

In the July 14, 2003 Scoping Memo, as amended July 23, 2003, Commission Staff was ordered to identify "CPUC's reasonable exposure in dollars if PG&E's claims against CPUC were litigated" and to "estimate the strength of CPUC's case in PG&E v. Lynch (Case No. C-01-3023-VRW)." The only available analysis the PUC has performed concerning the potential value of any PG&E claims against the PUC concerns the so-called "Rate-Recovery Litigation," Pacific Gas & Electric Company v. Lynch, No. 01-3023 (N.D. Cal.) This analysis, comprised of an Expert Report and Direct Testimony, was submitted as testimony in the PG&E federal bankruptcy case underlying these proceedings. A copy of the report and testimony on this issue submitted to the Bankruptcy Court is attached hereto as Exhibit B. I am unaware of any other "claims" that PG&E has against the PUC.

## E. The Settlement Agreement Provides Significant Environmental Protections and Enhancements

### 1. PG&E Donates in Fee or Provides Conservation Easements on 140,000 Acres of Watershed Lands

The proposed settlement would give the people of California control over, and access to, 140,000 acres of land associated with PG&E's hydroelectric facilities, without compromising the ability of PG&E to generate electricity from those facilities. Possible loss of public access to these lands is no theoretical worry – in

1999 PG&E proposed to sell these lands to the highest bidder[26]. The proposed settlement would remove forever that possibility, and replace the spectre of loss of public control with the promise of perpetual public access. The proposed settlement's provisions for PG&E's either donating the land or granting conservation easements go much further than simply maintaining the status quo – the people of California can look to a partnership of the environmental community, state and local governments, and environmental stewardship organizations to preserve the lands and improve public access where that's desirable. This result is unlikely to have been achieved without PG&E's consent – the need to get PG&E out of bankruptcy provides an opportunity to win that consent and establish a stewardship model for these lands that will stand for decades to come.

The Environmental Enhancement Corporation and its governing board established in the proposed settlement will guarantee that PG&E complies with the requirement to donate the lands or grant conservation easements under bankruptcy court supervision, and will provide significant public (and Commission) oversight and participation into improvements made to the lands and the lands' ultimate disposition. Membership of the governing board would include representatives from PG&E, the Commission, the California Department of Fish and Game, the State Water Resources Control Board, the California Farm Bureau Federation, and three public members to be named by the Commission. This board promises to play a historic role in California's environmental protection. Without a consensual resolution to the bankruptcy like the one offered by the proposed settlement, it is likely that no such board would ever exist and that the people's control over, and access to, PG&E's watershed lands

[26] PG&E Application for Authorization to Divest Its Hydroelectric Generating Facilities and Related Assets in Application (A.) 99-09-053.

would remain uncertain into the future. There should be no concern by the Commission that the proposed settlement's guarantees with respect to these lands threaten in any way the generation of electricity that is, after all, the reason for PG&E's owning the lands to begin with – the proposed settlement expressly provides that enhancements to the lands not "interfere with PG&E's hydroelectric operations, maintenance or capital improvements".[27]

### 2. PG&E Makes Commitments to Clean Energy Technology

Under the proposed settlement PG&E would also establish a shareholder-funded non-profit "dedicated to supporting research and investment in clean energy technologies primarily in PG&E's service territory."[28] The non-profit's governing board would include Commission-selected appointees, PG&E-selected appointees, and appointees jointly selected by the Commission and PG&E. The initial endowment of the non-profit would be modest -- $15 million over five years – but PG&E and the Commission would commit to working together to find more funding. The Commission should view this commitment as part of the Commission's, and the State's, ongoing policies encouraging energy efficiency, demand response, renewable generation, and the entire range of more environmentally-friendly options for meeting load growth. Neither dedication of the watershed lands to the public nor shareholder-funded research into clean energy technologies is likely to happen outside a settlement of PG&E's bankruptcy. The proposed settlement gives the Commission a historic opportunity to do both.

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[27] Settlement Agreement, Section 17. c.

[28] Settlement Agreement, Section 18. a.

### F. Capital Structure and Return on Equity for the Components of the Regulatory Asset

The July 14, 2003 Scoping Memo called for the proponents to clarify "the capital structure and return on the components of the regulatory asset." Appendix A: Technical Appendix to the Settlement Agreement (see Exhibit A) outlines the methodology of calculating the regulatory asset amortization and the illustrative revenue requirement resulting from the regulatory asset provided in the settlement agreement. The total revenue requirement for the regulatory asset will include the following ratepayer cost components:

- Regulatory asset amortization
- Taxes on the amortization
- Return on the average balance of the unamortized regulatory asset, grossed up for taxes

As illustrated in the table below, the estimated nominal ratepayer cost of the regulatory asset over nine years is about $5.3 billion.

| **Nominal Cost of the Regulatory Asset Over Nine Years** | In $Millions |
|---|---|
| Regulatory Asset Amortized Over Nine Years | $2,210 |
| Tax Component on Amortization[29] | $1,520 |
| Return Component Grossed-Up for Taxes[30] | $1,537 |
| Nominal Cost of the Regulatory Asset | $5,267 |

### G. Headroom Definition

The July 14, 2003 Scoping Memo called for clarification by the proponents regarding the definition of headroom. Specifically it ordered "if the definition of

[29] The tax component is pursuant to Settlement Agreement, Section 2 c.

"headroom" in the proposed settlement agreement differs from the Commission definition, please explain." Headroom as defined in the settlement agreement is not intended to differ from the mathematical outcome under the PUC's definition of headroom in Re Proposed Policies, etc., (1996) D.96-12-076, 70 CPUC 2d 207. As PG&E witness Christie McManus testifies in Chapter 10, the headroom as defined in the settlement agreement is mathematically equivalent to that in Re Proposed Policies, etc., (1996) D.96-12-076, 70 CPUC 2d 207.

### H. Choice of Nine-Year Life for the Regulatory Asset

The July 14, 2003 Scoping Memo called for clarification by the proponents regarding "[t]he choice of a nine-year life for the Regulatory Asset." Whether the proposed settlement is just and reasonable depends on the totality of its effect, which in turns depends on the effect of each of its provisions working together. As the PUC stated in San Diego Gas and Electric Company, D.92-12-019, 46 CPUC 2d 538 (1992): " we do not delve deeply into the details of the settlements and attempt to second-guess and reevaluate each aspect of the settlement, so long as the settlements as a whole are reasonable and in the public interest . . . " Id. (internal citation omitted). For the reasons described elsewhere in this testimony, it is my belief that, viewed in the context of the settlement agreement as a whole, the nine-year period is fair and reasonable. Nine years is sufficiently short to provide the needed cash flows to improve PG&E's credit statistics, while moderating rate impacts. Speculating about the effects of a different period would require speculation about the effects of changing numerous other provisions of the proposed agreement as well. The total agreement is the product of extensive arm's length negotiations and compromises and judgments,

[30] Pursuant to Settlement Agreement, Section 2. b. and c.

and it simply is not possible to discuss the effect or reason for an individual term in isolation.

### I. United States Bankruptcy Court Jurisdiction

The July 14, 2003 Scoping Memo called for clarification by the proponents regarding "Proposed S.A. para. 22 giving the United States Bankruptcy Court jurisdiction over all PG&E rate cases (and, perhaps, all PG&E matters) before the Commission for nine years. This appears to be a consent decree that binds future Commissions for nine years."

The effects of para. 22 are not so broad as the Scoping Memo suggests. Para. 22 only gives the Bankruptcy Court jurisdiction to enforce the settlement agreement. Matters addressed by the PUC that are not covered in the settlement agreement are not subject to Bankruptcy Court jurisdiction. So elements of PG&E rate cases not addressed in the settlement (administrative and general expenses for electric distribution, for example) are not for the Bankruptcy Court to decide.

The settlement agreement does contemplate binding future Commissions to its terms for nine years. The ability of the PUC to bind itself via contract was addressed in the Bankruptcy Proceeding, and Judge Montali concluded that the PUC could in fact bind itself to a contractual commitment, the so called "Reorganization Agreement," contemplated by the joint PUC/OCC Joint Plan. A copy of Judge Montali's order is attached to my testimony as Exhibit C. I am also attaching to my testimony as Exhibit D a letter prepared by the PUC's then-General Counsel, Gary Cohen, for rating agencies, discussing the ability of the PUC to bind itself to the Reorganization Agreement.

I declare under penalty of perjury that the foregoing is true and correct. I have personal knowledge of the facts stated herein, except as to matters stated upon information and belief, and as to those matters, I believe them to be true. If called upon to testify, I could and would competently do so.

Executed on July 25, 2003, at San Francisco, California.

/s/ Paul Clanon
Paul Clanon
Energy Division Director

# Appendix A

## Qualifications

I, Paul Clanon, am the Director of the Energy Division of the Public Utilities Commission (PUC). I assumed my current duties in 1997. As Director of the PUC's Energy Division, I manage the activities of about 100 analysts, accountants, engineers, and support staff in providing advisory and compliance support to the Commission in its regulation of energy utilities. Since joining the PUC in 1984 I've served as a staff analyst, Commissioner advisor, and manager in the energy field. I received a Bachelor's Degree in Economics from the University of California at Berkeley in 1983.

## Appendix B

LEVELIZED GENERATION RATE BASED ON COST OF SERVICE WITH THE COSTS ATTRIBUTABLE TO THE $2.21 BILLION REGULATORY ASSET IN THE SETTLEMENT AGREEMENT VS LEVELIZED RATE UNDER THE POWER SALES AGREEMENT (PSA) IN PG&E's DISAGGREGATION PLAN

Appendix B - SUMMARY

**LEVELIZED GENERATION RATE BASED ON COST OF SERVICE WITH THE COSTS ATTRIBUTABLE TO THE $2.21 BILLION REGULATORY ASSET IN THE SETTLEMENT AGREEMENT VS LEVELIZED RATE UNDER THE POWER SALES AGREEMENT (PSA) IN PG&E's DISAGGREGATION PLAN**

| Settlement Plan | | PG&E's Disaggregation Plan | | Difference |
|---|---|---|---|---|
| **Levelized Cost of Service Generation Rate** (cent/kWh) | 3.54 | | | |
| **Levelized Cost of the Regulatory Asset** (cent/kWh) | 1.53 | | | |
| **Levelized Cost of Service Rate with Cost of Regulatory Asset** (cent/kWh) | 5.07 | **Levelized Cost of PSA Rate** (cent/kWh) | 5.19 | (0.12) |
| **Average Inflation Adjusted Cost-Based Generation Cost** (in nominal $Billion/year) | $1.119 | **Average Generation Cost Under the PSA** (in nominal $Billion/year) | $1.638 | ($0.520) |
| **Average Cost of Regulatory Asset** (in nominal $Billion/year) | $0.439 | | | |
| **Average Generation Cost of Service with Cost of Regulatory Asset** (in nominal $Billion/year) | $1.558 | **Average Generation Cost Under the PSA** (in nominal $Billion/year) | $1.638 | ($0.080) |
| **Generation Cost of Service with Cost of Regulatory Asset** (in nominal $Billion for 12-year duration) | $ 18,692 | **Generation Cost Under the PSA** (in nominal $Billion for 12-year duration) | $ 19,661 | ($970) |

## Appendix B - WORKPAPER

# LEVELIZED GENERATION RATE BASED ON COST OF SERVICE WITH THE COSTS ATTRIBUTABLE TO THE $2.21 BILLION REGULATORY ASSET IN THE SETTLEMENT AGREEMENT VS LEVELIZED RATE UNDER THE POWER SALES AGREEMENT (PSA) IN PG&E's DISAGGREGATION PLAN

## Amounts in $Millions

| | | | | | | | | | | | | | 12-year Total | Annual Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | | |
| **Levelized Cost of Service Rate** | | | | | | | | | | | | | | |
| Inflation (1) | 2.4% | 2.7% | 2.7% | 2.7% | 2.7% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | | |
| 2002 URG Revenue Requirements Adjusted for Inflation(2) | 1008 | 1036 | 1,064 | 1,092 | 1,122 | 1,153 | 1,186 | 1,219 | 1,253 | 1,288 | 1,324 | 681 | | |
| Total Annual Revenue Requirements Under Cost of Service | **1,008** | **1,036** | **1,064** | **1,092** | **1,122** | **1,153** | **1,186** | **1,219** | **1,253** | **1,288** | **1,324** | **681** | **$ 13,425** | **$ 1,119** |
| Energy Production, GWh (3) | 33,008 | 32,266 | 32,667 | 32,667 | 32,667 | 32,667 | 28,805 | 32,427 | 32,187 | 32,187 | 31,388 | 15,706 | | |
| Cost of Service Generation Rate cent/kWh | 3.06 | 3.21 | 3.26 | 3.34 | 3.43 | 3.53 | 4.12 | 3.76 | 3.89 | 4.00 | 4.22 | 4.33 | | |
| **Levelized Cost of Service Generation Rate cent/kWh (4)** | **3.54** | | | | | | | | | | | | | |
| **Levelized Cost of Service Rate With the Cost of Regulatory Asset** | | | | | | | | | | | | | | |
| **Cost Attributable to the $2.21 Billion Regulatory Asset** | | | | | | | | | | | | | | |
| Annual Regulatory Asset Amortization | 142.7 | 161.4 | 182.6 | 206.5 | 233.6 | 264.2 | 298.8 | 338 | 382.3 | 0 | 0 | 0 | **$ 2,210** | $ 184 |
| Annual Regulatory Asset Amortization Tax Effect (5) | 98.1 | 111 | 125.6 | 142 | 160.6 | 181.7 | 205.5 | 232.5 | 262.9 | 0 | 0 | 0 | **$ 1,520** | $ 127 |
| Average Annual Return on Rate Base Component Grossed-up for Taxes (6) | 280.4 | 260.4 | 237.9 | 212.4 | 183.5 | 150.9 | 114.0 | 72.3 | 25.1 | 0 | 0 | 0 | **$ 1,537** | $ 128 |
| **Total Cost of Regulatory Asset** | **521.2** | **532.8** | **546.1** | **560.9** | **577.7** | **596.8** | **618.3** | **642.8** | **670.3** | 0 | 0 | 0 | **$ 5,267** | **$ 439** |
| PSA Energy Production, GWh (3) | 33,008 | 32,266 | 32,667 | 32,667 | 32,667 | 32,667 | 28,805 | 32,427 | 32,187 | 32,187 | 31,388 | 15,706 | | |
| Cost of Service Generation Rate cent/kWh | 1.58 | 1.65 | 1.67 | 1.72 | 1.77 | 1.83 | 2.15 | 1.98 | 2.08 | 0.00 | 0.00 | 0.00 | | |
| **Levelized Cost of Regulatory Asset cent/kWh (7)** | **1.53** | | | | | | | | | | | | | |
| **Generation Cost of Service with Cost of the Regulatory Asset** | **1,530** | **1,568** | **1,610** | **1,653** | **1,700** | **1,750** | **1,804** | **1,862** | **1,923** | **1,288** | **1,324** | **681** | **$ 18,692** | **$ 1,558** |
| **Cost of Service Rate with Cost of the Regulatory Asset cent/kWh** | **4.63** | **4.86** | **4.93** | **5.06** | **5.20** | **5.36** | **6.26** | **5.74** | **5.97** | **4.00** | **4.22** | **4.33** | | |
| **Levelized Cost of Service Rate with Cost of Regulatory Asset cent/kWh (8)** | **5.07** | | | | | | | | | | | | | |
| **Levelized Cost of Generation Under the PSA (9)** | | | | | | | | | | | | | | |
| **Capacity Payments** | 1,210 | 1,248 | 1,264 | 1,298 | 1,333 | 1,371 | 1,409 | 1,435 | 1,464 | 1,505 | 1,498 | 833 | | |
| **Energy Payments** | 256 | 257 | 267 | 274 | 282 | 290 | 262 | 304 | 310 | 319 | 319 | 159 | | |
| Helms Pumping Cost | 36 | 35 | 34 | 36 | 37 | 40 | 42 | 44 | 45 | 48 | 49 | 51 | | |
| **Total Generation Cost Under the PSA** | **1,502** | **1,539** | **1,565** | **1,608** | **1,652** | **1,701** | **1,712** | **1,782** | **1,819** | **1,872** | **1,867** | **1,043** | **$ 19,661** | **$ 1,638** |
| PSA Energy Production, GWh | 33,008 | 32,266 | 32,667 | 32,667 | 32,667 | 32,667 | 28,805 | 32,427 | 32,187 | 32,187 | 31,388 | 15,706 | | |
| **PSA Rate cent/kWh** | **4.55** | **4.77** | **4.79** | **4.92** | **5.06** | **5.21** | **5.94** | **5.50** | **5.65** | **5.81** | **5.95** | **6.64** | | |
| **Levelized PSA Rate cent/kWh (10)** | **5.19** | | | | | | | | | | | | | |

(1) Escalation rates are based on those used by Eugene T. Meehan in his workpapers supporting his Direct Testimony on behalf of Electric Generation LLC in FERC Docket No. ER02-456.

(2) Total Utility Retained Generation (URG) revenue requirement is estimated at $984.8 million as follows: hydroelectric facilities $458 million and Diablo Canyon Power Plant $461 million (based on approved Advice Letter 2233-E, which implements Decision 02-04-016, Opinion Adopting Revenue Requirements For Utility Retained Generation for 2002), and $65.8 million total for irrigation district and water agency contracts (from PG&E filing in the URG proceeding).

(3) Energy production amounts for years 1 through 11 are the same as those used by Eugene T. Meehan in his workpapers supporting Direct Testimony on behalf of Electric Generation LLC in FERC Docket No. ER02-456. Energy Division assumes the output for year 12 is half of year 11 because during the last year of the agreement, a portion of the output from the Diablo Canyon Power Plant and certain of the hydroelectric facilities will no longer be subject to the PSA. Meehan's testimony shows a near 50% drop in output under the PSA from year 11 to 12.

(4) Net present value (NPV) of Total Annual Revenue Requirements Under Cost of Service for years 1 thru 12 at 9% divided by the NPV of PSA Energy Production for years 1 through 12 at 9%, multiplied by 100.

(5) The Settlement Agreement provides PG&E with a $2.21 billion regulatory asset that amortizes over nine years and will increase PG&E's rate base by an equivalent amount. The tax effect is calculated based on the total amount of revenues that will be necessary to yield a net cash flow equivalent to the scheduled amortization, based on approximately 35% and 8.84% federal and state tax rates, respectively. Refer to Settlement Agreement - Appendix A, Section E.

(6) The annual return on rate base attributable to the regulatory asset balance is calculated by multiplying the average annual regulatory asset balance by an after-tax return on rate base. Refer to Settlement Agreement - Appendix A, Section E.

(7) NPV of Total Cost of Regulatory Asset for years 1 through 12 at 9% divided by the NPV of PSA Energy Production for years 1 through 12 at 9%, multiplied by 100.

(8) NPV of Cost of Service with Cost of Regulatory Asset for years 1 through 12 at 9% divided by the NPV of PSA Energy Production for years 1 through 12 at 9%, multiplied by 100.

(9) From workpapers in support of Eugene T. Meehan Direct Testimony on behalf of Electric Generation LLC in FERC Docket No. ER02-456 dated July 16, 2002.

(10) NPV of Total Generation Cost Under the PSA for years 1 through 12 at 9% divided by the NPV of PSA Energy Production for years 1 through 12 at 9%, multiplied by 100.

**Exhibit A**

[Proposed] Settlement Agreement

# SETTLEMENT AGREEMENT

This Settlement Agreement ("Agreement") is made and entered into by Pacific Gas and Electric Company ("PG&E"), PG&E Corporation (the "Parent" or "PG&E Corporation") (PG&E and PG&E Corporation are collectively referred to as the "PG&E Proponents"), and the Public Utilities Commission of the State of California, as of ___________, 2003 (each of which is individually referred to as a "Party," and collectively as the "Parties")

## Recitals

A. On April 6, 2001, PG&E filed a voluntary case under Chapter 11 of the United States Bankruptcy Code, Case No. 01-30923 DM (the "Chapter 11 Case"), pending in the United States Bankruptcy Court for the Northern District of California (the "Court").

B. The PG&E Proponents filed a Plan of Reorganization under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company, dated April 19, 2002, as Modified by Modifications Dated July 9, 2002, October 18, 2002, December 13, 2002, December 26, 2002, February 21, 2003, February 24, 2003, and May 22, 2003 (the "PG&E Plan").

C. On April 15, 2002, the Commission filed its original plan of reorganization for PG&E. Subsequently, the Commission and the Official Committee of Unsecured Creditors (the "OCC") appointed in the Chapter 11 Case filed a Second Amended Plan of Reorganization under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company, dated November 6, 2002. Then, on December 5, 2002, the Commission and the OCC filed their Third Amended Plan of Reorganization under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company (the "Commission Plan").

D. The Court began trial on the competing plans of reorganization on November 18, 2002. During the trial on the PG&E Plan, the Court entered an order staying further confirmation and related proceedings for 60 days to facilitate a mandatory settlement process before the Honorable Randall J. Newsome, Bankruptcy Judge. On April 23, 2003, at the request of Judge Newsome, the Court issued an order staying further confirmation and related proceedings for an additional 30 days. On June 9, 2003, the Court issued an order staying further confirmation and related proceedings for an additional four days, with a status conference scheduled for June 20, 2003.

E. Neither PG&E nor PG&E Corporation has declared or paid any dividends to holders of their common stock since October 2000, and are agreeing in this Agreement not to do so before July 1, 2004. As a result, PG&E's and PG&E Corporation's shareholders have foregone and will forego dividends of approximately $1.7 billion.

F. The Parties desire to settle their differences with respect to the competing plans of reorganization and the other matters specified herein, and to jointly support a plan of reorganization for PG&E (the "Settlement Plan"), all as set forth more specifically below.

G. In the exercise of its police and regulatory powers, the Commission is entering into this Agreement and shall adopt such decisions and orders as necessary to implement and carry out the provisions of this Agreement, including but not limited to, establishing Retail Electric Rates to provide for payment in full of the Securities and the Regulatory Asset (each as defined below) in accordance with their respective terms.

## Statement of Intent

(1) The Parties recognize that reliable electric and gas service is of the utmost importance to the safety, health, and welfare of California's citizenry and economy.

(2) The Parties expect that under the Settlement Plan, Retail Electric Rates (as defined below) will be reduced on January 1, 2004, with further reductions expected thereafter.

(3) As part of this Agreement, the PG&E Proponents will withdraw the PG&E Plan and no longer propose to disaggregate the historic businesses of PG&E. Instead, PG&E will remain a vertically-integrated utility subject to the Commission's jurisdiction to regulate in the public interest. Subject to the provisions of this Agreement, the Settlement Plan, and the Confirmation Order (as defined below), PG&E shall continue to be regulated by the Commission in accordance with the Commission's policies and practices and the laws and regulations applicable to similarly situated investor-owned utilities in the State of California.

(4) The Parties enter into this settlement to enable PG&E to emerge from Chapter 11 and fully resume its traditional role of providing safe and reliable electric and gas service at just and reasonable rates, subject to Commission regulation.

(5) It is in the public interest to restore PG&E to financial health and to maintain and improve PG&E's financial health in the future to ensure that PG&E is able to provide safe and reliable electric and gas service to its customers at just and reasonable rates. The Parties intend that PG&E emerge from Chapter 11 as soon as possible with a company credit rating of Investment Grade and that PG&E's company credit rating will improve over time. Investment Grade credit ratings are

necessary for PG&E to emerge from Chapter 11 and will directly benefit PG&E's ratepayers by reducing the cost of the financings (i) required for emergence and (ii) required to fund future operations and capital expenditures. In order to help accomplish these goals, it is fair and in the public interest to allow PG&E to recover, over a reasonable time, prior uncollected costs and to provide the opportunity for PG&E's shareholders to earn a reasonable rate of return on PG&E's utility business, all as described herein.

(6) Among other things, as part of this Agreement, PG&E will release claims against the Commission that would have been retained by PG&E or its Parent under the PG&E Plan. In lieu of those claims and the value that PG&E's shareholders would have received from the transactions provided for under the PG&E Plan, PG&E's shareholders will receive value over nine years through this Agreement, the Settlement Plan and the Confirmation Order (as defined below), including amortization of the Regulatory Asset as provided for herein.

(7) The Commission acknowledges and agrees that the benefit of this Agreement to PG&E's shareholders requires that the Commission provide timely and full recovery of PG&E's reasonable costs of providing utility service, including return of and return on investment in utility plant and recovery of operating expenses, including power procurement costs, over the full nine-year amortization period of the Regulatory Asset. The Commission intends to provide PG&E with the opportunity to recover all of its prudently incurred costs as well as a return of and return on its investment in utility plant. The Commission also intends that any operational mandate it imposes that requires PG&E to expend funds or incur costs,

including demand reduction or energy conservation programs, include a timely rate recovery mechanism for the costs of such mandate.

## Agreement

In consideration of the respective covenants and agreements contained in this Agreement and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

1. **Definitions.** When used in this Agreement, the following terms shall have the following meanings:

a. "96C Bonds" means those certain Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric) 1996 Series C issued by the California Pollution Control Financing Authority in the aggregate principal amount of $200,000,000.

b. "96E Bonds" means those certain Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric) 1996 Series E issued by the California Pollution Control Financing Authority in the aggregate principal amount of $165,000,000.

c. "96F Bonds" means those certain Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric) 1996 Series F issued by the California Pollution Control Financing Authority in the aggregate principal amount of $100,000,000.

d. "97B Bonds" means those certain Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric) 1997 Series B issued by the California Pollution Control Financing Authority in the aggregate principal amount of $148,550,000.

e. "Administrative Expense Claim" means a Claim against PG&E constituting a cost or expense of administration of the Chapter 11 Case under sections

503(b) and 507(a)(1) of the Bankruptcy Code, and any fees or charges assessed against the estate of PG&E under section 1930 of chapter 123 of title 28 of the United States Code.

f. "Agreement" has the meaning set forth in the introduction.

g. "ATCP Application" means PG&E's Annual Transition Cost Proceeding, Application No. 01-09-003, presently pending before the Commission.

h. "Business Day" means any day other than a Saturday, a Sunday or any other day on which commercial banks in San Francisco, California, or New York, New York, are required or authorized to close by law or executive order.

i. "Carizzo Plains" has the meaning set forth in Paragraph 17.

j. "Cash" means legal tender of the United States.

k. "Cause of Action" means, without limitation, any and all actions, causes of action, liabilities, obligations, rights, suits, damages, judgments, claims and demands whatsoever, whether known or unknown, existing or hereafter arising, in law, equity or otherwise, based in whole or in part upon any act or omission or other event occurring prior to April 6, 2001 or during the course of the Chapter 11 Case, including through the Effective Date.

l. "Chapter 11 Case" has the meaning set forth in Recital A.

m. "Commission" means the California Public Utilities Commission, or any successor agency, and the commissioners thereof in their official capacities and their respective successors.

n. "Commission-DWR Rate Agreement" means the agreement dated March 8, 2002, between the Commission and DWR relating to the establishment of

DWR's revenue requirements and charges in connection with power sold by DWR under Division 27, commencing with section 80000, of the California Water Code.

o. "Commission Plan" has the meaning set forth in Recital C.

p. "Confirmation Order" means the order of the Court confirming the Settlement Plan pursuant to section 1129 of the Bankruptcy Code.

q. "Court" has the meaning set forth in Recital A.

r. "DWR" means the California Department of Water Resources.

s. "DWR Contracts" means the contracts entered into by DWR for the purchase of electric power and associated goods and services pursuant to California Assembly Bill No. 1X, signed into law by the Governor on February 1, 2001.

t. "Effective Date" means the date designated in the Settlement Plan as the Effective Date.

u. "ESP" means energy service provider.

v. "FERC" means the United States Federal Energy Regulatory Commission.

w. "Fixed Transition Amount" has the meaning set forth in section 840(d) of the Public Utilities Code.

x. "Forecast Average Equity Ratio" means the proportion of equity in the forecast of PG&E's average capital structure for calendar year 2004 and 2005 to be filed by PG&E in its 2003 cost of capital proceeding, Application No. 02-05-022, and its 2005 cost of capital proceeding, respectively, or such other CPUC proceedings as may be appropriate.

y. "Headroom" means PG&E's total net after-tax income reported under Generally Accepted Accounting Principles, less earnings from operations, plus after-tax amounts accrued for bankruptcy-related administration and bankruptcy-related interest costs, all multiplied by 1.67, provided that the calculation will reflect the outcome of PG&E's 2003 general rate case (A.02-09-005 and A.02-11-067).

z. "Investment Grade" means credit ratings from both S&P of BBB- or better and Moody's of Baa3 or better.

aa. "Land Conservation Commitment" has the meaning set forth in Paragraph 17a.

bb. "Letter of Credit Backed PC Bonds" means, collectively, any series of 96C Bonds, 96E Bonds, 96F Bonds and/or 97B Bonds that are outstanding as of the Effective Date.

cc. "Long-Term Notes" means the long-term notes proposed to be issued to creditors pursuant to the PG&E Plan.

dd. "MBIA Insured PC Bonds" means those certain Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric Company) 1996 Series A issued by the California Pollution Control Financing Authority in the aggregate principal amount of $200,000,000.

ee. "Moody's" means Moody's Investor's Service Inc.

ff. "NRC" means the United States Nuclear Regulatory Commission.

gg. "OCC" has the meaning set forth in Recital C.

hh. "Parent" has the meaning set forth in the introduction.

ii. "Person" has the meaning set forth in section 101(41) of the Bankruptcy Code.

jj. "PG&E Plan" has the meaning set forth in Recital B.

kk. "Preferred Stock" means the issued and outstanding shares of PG&E's First Preferred Stock, par value $25.00 per share. PG&E's First Preferred Stock comprises: (a) 6% Non-Redeemable First Preferred; (b) 5.5% Non-Redeemable First Preferred; (c) 5% Non-Redeemable First Preferred; (d) 5% Redeemable First Preferred Series D; (e) 5% Redeemable First Preferred Series E; (f) 4.80% Redeemable First Preferred; (g) 4.50% Redeemable First Preferred; (h) 4.36% Redeemable First Preferred; (i) 6.57% Redeemable First Preferred; (j) 7.04% Redeemable First Preferred; and (k) 6.30% Redeemable First Preferred.

ll. "QFs" means qualifying facilities operating pursuant to the Public Utility Regulatory Policies Act of 1978 and related regulations enacted thereunder.

mm. "Rate Recovery Litigation" means *Pacific Gas & Electric Company, Plaintiff, v. Loretta M. Lynch, et al., Defendants*, Case No. C-01-3023-VRW, filed in the United States District Court for the Northern District of California, and all appellate proceedings arising therefrom.

nn. "Rate Reduction Bonds" has the meaning set forth in section 840(e) of the Public Utilities Code.

oo. "Regulatory Asset" has the meaning set forth in Paragraph 2.

pp. "Retail Electric Rates" means any and all charges authorized by the Commission to be collected from PG&E's retail electric customers.

qq. "ROE" has the meaning set forth in Paragraph 2b.

rr. "S&P" means Standard & Poor's, a division of The McGraw-Hill Companies, Inc.

ss. "SEC" means the United States Securities and Exchange Commission.

tt. "Securities" means the debt and Preferred Stock to be issued or reinstated by PG&E, as the case may be, in accordance with the Settlement Plan, from time to time, including any and all interest thereon or associated costs as provided under such debt or Preferred Stock instruments, agreements or certificates.

uu. "Settlement Plan" has the meaning set forth in Recital E.

vv. "State" means the State of California.

ww. "Tax Tracking Account" has the meaning set forth in Paragraph 2c.

xx. "TCBA" means Transition Cost Balancing Account.

yy. "URG" means utility retained generation.

zz. "URG Rate Base" means the rate base amounts set forth in PG&E Advice Letter 2233-E implementing Commission Decision (D.) No. 02-04-016.

aaa. "Watershed Lands" has the meaning set forth in Paragraph 17.

**2. Regulatory Asset.** The Commission shall establish a regulatory asset of Two Billion Two Hundred and Ten Million Dollars ($2,210,000,000) as a new, separate and additional part of PG&E's rate base (the "Regulatory Asset").

a. The Regulatory Asset shall be amortized in PG&E's Retail Electric Rates on a "mortgage-style" basis over nine years starting on January 1, 2004. The details and mechanics of the amortization and earnings of the Regulatory Asset shall be as set forth in Appendix A, Technical Appendix, jointly prepared by the Commission and PG&E.

b. The Regulatory Asset shall earn PG&E's authorized return on equity ("ROE") on the equity component of PG&E's capital structure as set in PG&E's annual cost of capital proceedings, provided that the ROE on the Regulatory Asset shall be no less than 11.22 percent per year for the life of the Regulatory Asset and that, once the equity component of PG&E's capital structure reaches 52 percent, the authorized equity component for the Regulatory Asset shall be no less than 52 percent for the life of the Regulatory Asset.

c. The Commission will use its usual methodology for tax-effecting the ROE component for purposes of setting PG&E's revenue requirements associated with the unamortized portion of the Regulatory Asset. The Commission will apply the same method of tax-effecting to the scheduled amortization of the Regulatory Asset. The Commission shall authorize PG&E to establish a Tax Tracking Account to be used as follows: In the event that it is finally determined that PG&E is required to pay income taxes on the Regulatory Asset any earlier than the Regulatory Asset is amortized pursuant to Paragraph 2a, PG&E shall record in the Tax Tracking Account the difference between (1) the taxes incurred on account of the Regulatory Asset plus any interest imposed by the federal or state taxing authorities with respect to such earlier recognition of taxable income and (2) the taxes that would have been incurred on account of the Regulatory Asset had it been subject to tax as it was amortized pursuant to Paragraph 2a. The Tax Tracking Account shall earn PG&E's authorized rate of return in accordance with the provisions of Paragraph 2b. PG&E shall amortize the Tax Tracking Account in Retail Electric rates over the greater of the remaining life of the Regulatory Asset or five years.

d. PG&E shall continue to cooperate with the Commission and the State in seeking refunds from generators and other energy suppliers. The net after-tax amount of any refunds, claim offsets or other credits from generators or other energy suppliers relating to PG&E's PX, ISO, QF or ESP costs that PG&E actually realizes in Cash or by offset of creditor claims in the Chapter 11 Case shall be applied by PG&E to reduce the outstanding balance of the Regulatory Asset dollar for dollar. To the extent that any consideration actually received by PG&E in Cash under the Master Settlement Agreement that resolves the litigation in *Public Utilities Commission of California v. El Paso Natural Gas Co., et al.,* FERC Docket No. RP00-241-000, *et al.*, and related litigation in state and federal courts, is in settlement of damages claimed by PG&E that caused PG&E to incur high costs of electricity from March 1, 2000 to date, PG&E shall apply the net after-tax amount of such consideration to reduce the outstanding balance of the Regulatory Asset dollar for dollar, provided that such a reduction is consistent with the rules or orders adopted by the Commission concerning the consideration paid by El Paso under the Master Settlement Agreement. These reductions shall reduce the remaining amortization of the Regulatory Asset, as set forth in Appendix A, Technical Appendix.

e. Balances in PG&E's TCBA, determined in accordance with Commission Decision No. 01-03-082, as of January 1, 2004 shall have no further impact on PG&E's Retail Electric Rates and shall be subject to no further review by the Commission except for verification of recorded balances, and PG&E's current Retail Electric Rates will be replaced by the Retail Electric Rates resulting from this Agreement, the Settlement Plan and the Confirmation Order as of January 1, 2004. This is not intended to affect PG&E's pending application (Application No. 00-07-013) to recover electric restructuring costs booked into the Electric Restructuring Cost Account pursuant to Public Utilities Code section 376 or to otherwise affect recovery of QF and other nonbypassable costs going forward.

f. The Commission agrees that PG&E should receive the benefit of this Agreement over the entire life of the Regulatory Asset. To ensure this, the Commission agrees that the URG Rate Base for PG&E already established by the Commission in D.02-04-016 shall be deemed just and reasonable and not subject to modification, adjustment or reduction, except as necessary to reflect capital expenditures and any change in authorized depreciation. (This shall not preclude the Commission from determining the reasonableness of any capital expenditures made on URG after the Effective Date.) The Commission further agrees that it shall not in any way reduce or impair the value of the Regulatory Asset or the URG Rate Base by taking the Regulatory Asset or the URG Rate Base, their amortization or earnings into account when setting other revenue requirements and resulting rates for PG&E. Nor shall the Commission take this Agreement or the Regulatory Asset into account in establishing PG&E's authorized ROE or capital structure.

g. The Commission recognizes that the establishment, maintenance and improvement of Investment Grade company credit ratings is vital for PG&E to be able to continue to provide safe and reliable service to its customers. The Commission further recognizes that the establishment, maintenance and improvement of PG&E's Investment Grade company credit ratings directly benefits PG&E's ratepayers by reducing PG&E's immediate and future borrowing costs, which, in turn, will allow PG&E to finance its operations and make capital expenditures on its distribution, transmission, and generation assets at lower cost to its ratepayers. In furtherance of these objectives, the Commission agrees to act to facilitate and maintain Investment Grade company credit ratings for PG&E.

h. As part of ensuring that PG&E has the opportunity to recover all its prudently incurred costs of providing service, including return of and return on utility investment, the Commission agrees that it shall timely act upon PG&E's applications to collect in rates its prudently incurred costs (including return of and return on) of any new, reasonable investment in utility plant and assets.

i. The Commission shall promptly adjust PG&E's rates consistent with AB 57/SB 1976 and the Commission-DWR Rate Agreement to ensure that PG&E's collection of the following is not impaired: (1) Fixed Transition Amount to service existing Rate Reduction Bonds; (2) Regulatory Asset amortization and return; and (3) base revenue requirements (*e.g.,* electric and gas distribution, URG, gas commodity procurement, existing QF contract costs and associated return).

j. The Commission agrees that, in the absence of compelling evidence to the contrary, PG&E's expected regulatory outcomes and financial performance should be similar to those of the other investor-owned energy utilities in California under similar circumstances. In furtherance of the foregoing, the Commission shall not discriminate against PG&E by reason of the Chapter 11 Case, the Rate Recovery Litigation, this Agreement, the Regulatory Asset or any other matters addressed or resolved herein.

**3. <u>Ratemaking Matters</u>.**

a. The Commission agrees to maintain PG&E's Retail Electric Rates at current levels through December 31, 2003. As of January 1, 2004, the Commission may adjust PG&E's Retail Electric Rates prospectively consistent with this Agreement, the Settlement Plan, the Confirmation Order and California law.

b. The Commission shall set PG&E's capital structure and authorized ROE in PG&E's annual cost of capital proceedings in its usual manner; provided that, from January 1, 2004 until either S&P confers on PG&E a company credit rating of at least "A-" or Moody's confers on PG&E a company credit rating of at least "A3," the authorized ROE shall be no less than 11.22 percent per year and the authorized equity ratio for ratemaking purposes shall be no less than 52 percent, except for a transition period as provided below. The Commission recognizes that, at the Effective Date, PG&E's capital structure will likely not contain 52 percent equity. Accordingly, for 2004 and 2005, the authorized equity ratio shall equal the Forecast Average Equity Ratio, but in no event shall it be less than 48.6 percent. Notwithstanding the provisions of Paragraph 6, PG&E agrees not to pay any dividend on common stock before July 1, 2004.

c. Nothing in this Agreement shall be construed to create a rate freeze or rate cap for PG&E's electric or gas business.

**4. Implementation of Ratemaking.** To ensure that all conditions to the Effective Date are met as soon as possible following issuance of the Confirmation Order, as soon as practicable after the Commission decision approving this Agreement, PG&E shall file an advice letter to implement all the rate and tariff changes necessary to implement the Settlement Plan. The Commission shall act promptly on the advice filing and revised rates and tariffs. The Commission shall also review and issue a decision promptly on the merits of any application for rehearing of the approval of the advice filing.

**5. Timely Decisions on Ratemaking Matters.** The Commission and PG&E agree that timely applications by PG&E and timely action by the Commission on such applications are essential to the achievement of the objectives of this settlement. The Commission agrees that it will promptly act on the pending PG&E ratemaking proceedings listed in Appendix B hereto.

**6. Dividend Payments and Stock Repurchases.** The Parties acknowledge that, for the Parent, as PG&E's shareholder, to receive the benefit of this Agreement, both PG&E and its Parent must be able to pay dividends and repurchase common stock when appropriate. Accordingly, the Parties agree that, other than the capital structure and stand-alone dividend conditions contained in the PG&E holding company decisions (D.96-11-017 and D.99-04-068), the Commission shall not restrict the ability of the boards of directors of either PG&E or PG&E Corporation to declare and pay dividends or repurchase common stock.

**7. DWR Contracts.** If the Commission desires it, PG&E agrees to accept an assignment of or to assume legal and financial responsibility for the DWR Contracts, provided that (a) PG&E's company credit rating, after giving effect to such assignment or assumption, shall be no less than "A" from S&P and "A2" from Moody's; (b) the Commission shall first have made a finding that, for purposes of assignment or assumption, the DWR Contracts to be assigned or assumed are just and reasonable; and (c) the Commission shall have acted to ensure that PG&E will receive full and timely recovery in its Retail Electric Rates of all costs of such DWR Contracts over their life without further review. The Commission agrees not to require PG&E to assume or accept an assignment of legal or financial responsibility for the DWR Contracts unless conditions (a), (b) and (c) are all met. Nothing in this paragraph shall be construed to limit the discretion of the Commission to review the prudence of PG&E's administration and dispatch of the DWR Contracts, consistent with applicable law.

**8. Headroom Revenues.**

a. The Commission acknowledges and agrees that the Headroom, surcharge, and base revenues accrued or collected by PG&E through and including December 31, 2003 are property of PG&E's Chapter 11 estate, have been or will be used for utility purposes, including to pay creditors in the Chapter 11 Case, have been included in PG&E's Retail Electric Rates consistent with state and federal law, and are not subject to refund.

b. The Headroom revenues accrued by PG&E during calendar year 2003 shall not exceed $875 million and shall not be less than $775 million, both on a pre-tax basis. If the amount of Headroom PG&E accrues in 2003 is greater or less than these amounts, the Commission shall take such action in 2004 as is necessary to require PG&E to refund any Headroom accrued in excess of $875 million or, if the accrued Headroom is less than $775 million, to allow PG&E to collect in rates the difference between the Headroom accrued and $775 million.

**9. Dismissal of the Rate Recovery and Other Litigation.** On or as soon as practicable after the later of the Effective Date or the date on which the Commission approval of this Agreement is no longer subject to appeal, PG&E shall dismiss with prejudice the Rate Recovery Litigation, foregoing any recovery from ratepayers of costs sought in such litigation not otherwise provided for in this Agreement and the Settlement Plan; withdraw the PG&E Plan; dismiss other pending proceedings, as specified herein;

and provide the other consideration described herein. In exchange, on or before January 1, 2004, the Commission shall establish and authorize the collection of the Regulatory Asset and the URG Rate Base, and on or as soon as practicable after the Effective Date, the Commission shall resolve Phase 2 of the presently pending ATCP Application with no adverse impact on PG&E's cost recovery as filed, and provide the other consideration described herein. PG&E's motion to dismiss the Rate Recovery Litigation shall be in form and substance satisfactory to the Commission.

**10. Dismissal of Other Proceedings.** On or as soon as practicable after the later of the Effective Date or the date on which the Commission approval of this Agreement is no longer subject to appeal, PG&E and PG&E Corporation, on the one hand, and the Commission, on the other, will execute full mutual releases and dismissals with prejudice of all claims, actions or regulatory proceedings arising out of or related in any way to the energy crisis or the implementation of A.B. 1890 listed on Appendix C hereto. All such releases and dismissals with prejudice shall be in form and substance satisfactory to PG&E, PG&E Corporation and the Commission.

**11. Withdrawal of Certain Applications.**

a. Promptly upon the Effective Date, PG&E shall withdraw all of its applications previously filed with the FERC, the NRC, the SEC and elsewhere in connection with the PG&E Plan. A full and complete list of such applications is set forth in Appendix D hereto. Upon execution of this Agreement, PG&E and PG&E Corporation shall move to obtain or otherwise request a stay of all actions before the FERC, NRC, SEC or a similar agency initiated by PG&E and/or PG&E Corporation to implement the PG&E Plan. In addition, upon execution of this Agreement by all Parties, PG&E and PG&E

Corporation shall suspend all actions to obtain or transfer licenses, permits and franchises to implement the PG&E Plan. On the Effective Date or as soon thereafter as practicable, PG&E and PG&E Corporation shall withdraw or abandon all such applications for licenses, permits and franchises.

b. In addition to withdrawing its pending applications at FERC, PG&E and PG&E Corporation agree that, for the life of the Regulatory Asset, neither they nor any of their affiliates or subsidiaries will make any filing under Sections 4, 5 or 7 of the Natural Gas Act to transfer ownership of or ratemaking jurisdiction over PG&E's intrastate natural gas pipeline and storage facilities, and to keep such natural gas pipeline and storage facilities subject to the regulation of the Commission. In addition, PG&E and PG&E Corporation agree that the Commission has jurisdiction under existing Public Utilities Code section 851 to review and approve any proposal by PG&E to dispose of property necessary or useful in the performance of PG&E's duties to the public.

**12. <u>Interest Rate Hedging</u>.** In order to take advantage of the current favorable interest-rate climate, the Commission agrees that the actual reasonable cost of PG&E's interest rate hedging activities with respect to the financing necessary for the Settlement Plan shall be reflected and recoverable in PG&E's retail gas and electric rates without further review.

**13. <u>Financing</u>.**

a. It is anticipated that all of PG&E's existing trade and financial debt, except for the MBIA Insured PC Bonds and the Letter of Credit Backed PC Bonds, shall be paid in Cash under the Settlement Plan. It is further anticipated that the MBIA Insured PC Bonds, the Letter of Credit Backed PC Bonds and the Preferred Stock shall be reinstated under the Settlement Plan. The Settlement Plan will detail the proposed financing and creditor treatment.

b. The financing of the Settlement Plan shall not include any new preferred or common stock.

c. All financing shall be arranged and placed by a financing team led by PG&E that includes representatives of the Commission and PG&E and shall be duly authorized by the Commission and subject to the authority and duty of the boards of directors of PG&E and PG&E Corporation to approve such financing. The financing shall be designed and accomplished so as to minimize the cost to ratepayers consistent with achieving an appropriate and financially flexible capital structure.

d. In consideration for the agreement by UBS Warburg LLC and Lehman Brothers each to (i) limit its consummation and/or advisory fee to $20 million (in the case of Lehman Brothers inclusive of advisory fees already paid by PG&E Corporation and further subject to the crediting provisions contained in Lehman Brothers' engagement letter, and, in the case of UBS Warburg LLC, in lieu of the full consummation fee calculated pursuant to section 2(d) of UBS Warburg LLC's engagement letter with the Commission and the OCC), which shall be payable on the Effective Date, and (ii) jointly provide the bank facilities determined by PG&E to be necessary under the Settlement Plan (subject to negotiation of satisfactory terms and conditions), PG&E agrees to name UBS Warburg LLC and Lehman Brothers as exclusive book runners, lead managers and hedging providers of all financings pursuant to the Settlement Plan with equal economics for 80 percent of the aggregate of total fees and commissions payable on such financings, and otherwise on customary terms as agreed among them. To the extent that PG&E adds co-managers, the Commission shall have the right to appoint one additional co-manager at the highest level of economics available to co-managers.

e. All documents used or prepared by PG&E in connection with the financing, including prospectuses, indentures and notes, shall be in form and substance reasonably satisfactory to the Commission.

f. The cost of the financing, including principal, interest, any fees or discounts payable to investment bankers, capital markets arrangers or book runners, including the fees to be paid to UBS Warburg LLC and Lehman Brothers pursuant to Paragraph 13d, as well as any past or future call premiums on reacquired debt, shall be fully recoverable as part of the cost of debt to be collected in PG&E's retail gas and electric rates without further review.

**14. Treatment of Creditors.** The treatment of creditors under the Settlement Plan will be consistent with that provided in the PG&E Plan, except that those creditors that were to receive Long-Term Notes or a combination of Cash and Long-Term Notes will be paid entirely in Cash.

**15. Fees and Expenses.** As of the Confirmation Date, and pursuant to the Settlement Plan and the Confirmation Order, PG&E shall reimburse PG&E Corporation and the Commission for all of their respective professional fees and expenses incurred in connection with the Chapter 11 Case (such fees and expenses of the Commission to include those of Paul, Weiss, Rifkind, Wharton & Garrison LLP, UBS Warburg LLC and Chanin Capital Partners), without the need for any application under Section 330 or 503(b) of the Bankruptcy Code. If it is determined by court order that such an application is required for all or any part of such fees and expenses, then the Parties shall support such application in a written pleading to be filed with the Court and such fees and expenses shall be allowed and treated as an Administrative Expense Claim under the Settlement Plan in the amount approved by the Court. The Commission shall authorize PG&E to recover the amounts so paid or reimbursed to the Commission in retail rates over a reasonable period of time, not to exceed four years. PG&E shall not recover any portion of the amounts so paid or reimbursed to PG&E Corporation in retail rates; rather, such costs shall be borne solely by shareholders through a reduction in retained earnings.

16. **Conditions Precedent to Effective Date.** Among other conditions to be contained in the Settlement Plan, the following shall be conditions precedent to the Effective Date:

a. S&P and Moody's shall have issued Investment Grade company credit ratings for PG&E.

b. The Commission shall have given final, nonappealable approval for all rates, tariffs and agreements necessary to implement the Settlement Plan. The PG&E Proponents shall have the right to waive this provision with respect to any appeal from the Commission's approvals.

17. **Preservation and Environmental Enhancement of PG&E Land.** PG&E owns approximately 140,000 acres of watershed lands ("Watershed Lands") associated with its hydroelectric generating system and the approximately 655 acre Carizzo Plains property in San Luis Obispo County ("Carizzo Plains"). Of the Watershed Lands, approximately 95,000 acres are lands that are either included in the project boundaries, contain essential project elements related to the operations of the hydro facilities, or are part of legal parcels that contain major FERC project facilities. The remaining 44,000 acres

are lands completely outside the FERC project boundaries and do not contain FERC project features. The Watershed Lands and Carizzo Plains are worth an estimated $300 million.

a. PG&E agrees to the Land Conservation Commitment set forth in Appendix E hereto, by which the Watershed Lands and Carizzo Plains will be subject to conservation easements or donated in fee simple to public agencies or non-profit conservation organizations.

b. On the Effective Date or as soon thereafter as practicable, PG&E shall establish PG&E Environmental Enhancement Corporation, a California non-profit corporation, to oversee the Land Conservation Commitment and to carry out environmental enhancement activities. The governing board of PG&E Environmental Enhancement Corporation will consist of one representative each from PG&E, the Commission, the California Department of Fish and Game, the State Water Resources Control Board, the California Farm Bureau Federation, and three public members to be named by the Commission.

c. PG&E shall fund PG&E Environmental Enhancement Corporation with $70 million in Cash to cover administrative expenses and the costs of environmental enhancements to the Watershed Lands and Carizzo Plains, provided that no such enhancement may at any time interfere with PG&E's hydroelectric operations, maintenance or capital improvements. The funds will be paid in equal installments over ten years on the Effective Date and on January 2 of each year thereafter. The Commission shall authorize PG&E to recover these payments in retail rates without further review.

**18. Clean Energy Technology Commitment.**

a. On the Effective Date or as soon thereafter as practicable, PG&E shall establish a new, California non-profit corporation dedicated to supporting research and investment in clean energy technologies primarily in PG&E's service territory. The non-profit corporation will be governed by a board consisting of nine members, three each appointed by the Commission and PG&E, and the remaining three to be selected jointly by the Commission appointees and the PG&E appointees.

b. PG&E shall fund the non-profit corporation with $15 million in Cash paid over five years, as follows: $1 million in the first year, $2 million in the second year, $3 million in the third year, $4 million in the fourth year, and $5 million in the fifth year, each amount payable on January 2 of each year after the Effective Date. The Commission shall not include any portion of this funding in PG&E's retail rates.

c. PG&E and the Commission shall work together to attract additional funding for the non-profit corporation.

**19. Cooperation.** The Parties will cooperate fully and in good faith to obtain timely confirmation of the Settlement Plan and to effectuate the transactions contemplated by this Agreement and the Settlement Plan. The Parties will support this Agreement, the Settlement Plan, and the Confirmation Order in all judicial, administrative and legislative forums. PG&E, PG&E Corporation and the Commission will cooperate in all presentations to credit rating agencies in connection with the consummation of the Settlement Plan.

**20. Waiver of Sovereign Immunity.** In connection with any action or proceeding concerning the enforcement of this Agreement, the Settlement Plan or the

Confirmation Order or other determination of the Parties' rights under this Agreement, the Settlement Plan or the Confirmation Order, the Commission hereby knowingly and expressly waives all existing and future rights of sovereign immunity, and all other similar immunities, as a defense. Accordingly, the Commission hereby consents to the jurisdiction of any court or other tribunal or forum for such actions or proceedings including, but not limited to, the Court. This waiver is irrevocable and applies to the jurisdiction of any court, legal process, suit, judgment, attachment in aid of execution of a judgment, attachment prior to judgment, set-off or any other legal process with respect to the enforcement of this Agreement, the Settlement Plan or the Confirmation Order or other determination of the Parties' rights under this Agreement, the Settlement Plan or Confirmation Order. It is the intention of this Agreement that neither the Commission nor any other California entity acting on the Commission's behalf may assert immunity in an action or proceeding, as discussed herein, concerning the Parties' rights under this Agreement, the Settlement Plan or the Confirmation Order.

**21.** **Validity and Binding Effect.** The Parties agree not to contest the validity and enforceability of this Agreement, the Settlement Plan or any order entered by the Court contemplated by or required to implement this Agreement and the Settlement Plan. This Agreement, the Settlement Plan and any such orders are intended to be enforceable under federal law, notwithstanding any contrary state law. This Agreement and the Settlement Plan, upon becoming effective, and the orders to be entered by the Court as contemplated hereby and under the Settlement Plan, shall be irrevocable and binding upon the Parties and their successors and assigns, notwithstanding any future decisions and orders of the Commission.

22. **Enforcement**. The Parties agree that the Court shall retain jurisdiction over the Parties for all purposes relating to enforcement of this Agreement, the Settlement Plan and the Confirmation Order.

23. **Specific Performance**. It is understood and agreed by each of the Parties hereto that money damages would not be a sufficient remedy for any material breach of any provision of this Agreement by any Party, and each non-breaching Party shall be entitled to specific performance and injunctive or other equitable relief as a remedy for any such breach, without the necessity of securing or posting a bond or other security in connection with such remedy.

24. **Releases**. The "Releases by Debtor" provided for in the Settlement Plan shall include PG&E Corporation, its present and former officers, directors, management, and professionals; the present or former members of the OCC, the present or former officers and directors and management of any present or former member of the OCC; and the Commission, its present and former commissioners and employees, as well as the advisors, consultants and professionals of or to the OCC, the members of the OCC, and the Commission, in each case in their respective capacities as such.

25. **Counterparts**. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

26. **Captions and Paragraph Headings**. Captions and paragraph headings used herein are for convenience only and are not a part of this Agreement and shall not be used in construing it.

27. **Entire Agreement.** This Agreement, together with the Settlement Plan and the Confirmation Order, contains the entire understanding of the Parties concerning the subject matter of this Agreement and, except as expressly provided for herein, supersedes all prior understandings and agreements, whether oral or written, among them with respect to the subject matter hereof and thereof. There are no representations, warranties, agreements, arrangements or understandings, oral or written, between the Parties hereto relating to the subject matter of this Agreement and such other documents and instruments which are not fully expressed herein or therein. This Agreement may be amended or modified only by an agreement in writing signed by each of the Parties hereto which is filed with and, if necessary, approved by, the Court.

28. **Time of Essence.** Time is hereby expressly made of the essence with respect to each and every term and provision of this Agreement upon its effectiveness. The Parties acknowledge that each will be relying upon the timely performance by the others of their obligations hereunder as a material inducement to each Party's execution and approval of this Agreement.

29. **No Third Party Beneficiaries.** Except as may be specifically set forth in this Agreement or the Settlement Plan, nothing in this Agreement, whether express or implied, is intended to confer any rights or remedies under or by reason of this Agreement on any Persons other than the Parties and their respective permitted successors and assigns, nor is anything in this Agreement intended to relieve or discharge the obligation or liability of any third Persons to any Party, nor give any third Persons any right of subrogation or action against any Party.

30. **Authority; Enforceability.** Each Party represents and warrants to the others that this Agreement has been duly authorized by all action required of such Party to be bound thereby, and that this Agreement, when effective, constitutes valid, binding and enforceable obligations of such Party.

31. **Waiver of Compliance.** To the extent permitted by applicable law, any failure of any of the Parties to comply with any obligation, covenant, agreement or condition set forth herein may be waived by the Party entitled to the benefit thereof only by a written instrument signed by such Party, but any such waiver shall not operate as a waiver of, or estoppel with respect to, any prior or subsequent failure to comply therewith. The failure of a Party to this Agreement to assert any of its rights under this Agreement or otherwise shall not constitute a waiver of such rights.

32. **California Law.** This Agreement shall be governed by, and shall be construed and enforced in accordance with, the laws of the State of California, without giving effect to the conflict of law principles thereof, except that this Agreement, the Settlement Plan and any orders of the Court (including the Confirmation Order) are intended to be enforceable under federal law, notwithstanding any contrary state law.

33. **Admissions.** This Agreement is a compromise believed by the Parties to be in the best interests of all concerned parties. Nothing in this Agreement shall be construed or deemed to be an admission by any of the Parties of any liability or any material fact in connection with any other litigation or proceeding.

34. **Confirmation Order.** The Confirmation Order shall, among other things, order the Parties to perform under and in accordance with this Agreement and the

Settlement Plan. The Confirmation Order shall be in form and substance satisfactory to each of the Parties.

**35. <u>Plan Documents</u>.** This Agreement is expressly conditioned on the preparation and approval by the Court of the Settlement Plan, the disclosure statement for the Settlement Plan, and the Confirmation Order, each of which shall be in form and substance reasonably satisfactory to each of the Parties.

**36. <u>Termination</u>.** This Agreement shall terminate at the end of nine (9) years from the Effective Date, <u>provided that</u> all rights of the Parties under this Agreement that vest on or prior to such termination, including any rights arising from any default under this Agreement, shall survive such termination for the purpose of enforcing such vested rights.

**37. <u>Conditions Precedent to Effectiveness</u>.** This Agreement shall only be binding upon the Parties and their respective successors and assigns and enforceable in accordance with its terms upon: (1) approval by the boards of directors of PG&E and PG&E Corporation, (2) approval by the Commission, and (3) execution of this Agreement by all Parties on or before December 31, 2003.

_______, 2003 CALIFORNIA PUBLIC UTILITIES COMMISSION

By____________________________________
Its____________________________________

PACIFIC GAS AND ELECTRIC COMPANY

_______, 2003

By____________________________________
Its____________________________________

PG&E CORPORATION

_______, 2003

By_____________________________________________

Its_____________________________________________

# APPENDIX A
# TECHNICAL APPENDIX

## APPENDIX B
## LIST OF PROCEEDINGS

A.00-05-002, -003, -004; -005; A.01-05-003, -009, -017, -018; A.02-05-002, -003, -005, -007, Annual Earnings Assessment Proceeding (AEAP) applications.

A.01-09-003, PG&E 2001 Annual Transition Cost Proceeding, Phase 1 cost recovery issues.

A.02-06-019, PG&E's 2002 Attrition Proceeding.

A.99-03-039, Public Utilities Code Section 368(e) proceeding.

A.00-07-013, PG&E Electric Restructuring Cost Account application.

A.02-11-017 and A.02-09-005, PG&E 2003 General Rate Case applications.

## APPENDIX C
## OTHER PROCEEDINGS TO BE DISMISSED

Various market valuation applications under AB 1890, Public Utilities Code Section 367(b) in Docket Nos. A.99-09-053, A.00-05-029, -030, -031, -032, -033, -034, -035.

A.00-06-046, PG&E application to implement benefit sharing ratemaking for Diablo Canyon pursuant to CPUC Diablo Canyon restructuring decisions. (Probably superseded by D.02-04-016, URG decision.)

I.01-04-002, CPUC investigation into past holding company actions during energy crisis (but only as to past actions, not prospective matters).

**APPENDIX D**
**CERTAIN APPLICATIONS**

(a) Applications to Transfer Regulatory Assets filed with the FERC in Docket Nos. EC02-3 1, EL02-36, ES02-17, ER02-456, and ER02-455

(b) Applications to Transfer Hydro Assets filed with FERC in Project Nos. 77-116, 96-031, 137-031, 175-018, 178-015, 233-082, 606-020, 619-095, 803-055, 1061-056, 1121-058, 1333-037, 1354-029, 1403-042, 1962-039, 1988-030, 2105-087, 2106-039, 2107-012, 2130-030, 2155-022, 2310-120, 2467-016, 2661-016, 2687-022, 2735-071, 2118-006, 2281-005, 2479-003, 2678-001, 2781-004, 2784-001, 4851-004, 5536-001, 5828-003, 7009-004, and 10821-002.

(c) Applications for Certificates of Public Convenience and Necessity filed with FERC in Docket Nos. CP02-38, CP02-39, CP02-40, CP02-41, and CP02-42.

(d) License Transfer Application filed with the NRC in Docket Nos. 50-275-LT, and 50-323-LT.

(e) Filing with the SEC for Approval under the Public Utilities Holding Company Act of 1935 to create Electric Generation LLC, ETrans LLC, and GTrans LLC.

## APPENDIX E
## LAND CONSERVATION COMMITMENT

### STATEMENT OF PURPOSE

PG&E shall ensure that the Watershed Lands it owns and Carizzo Plains are conserved for a broad range of beneficial public values, including the protection of the natural habitat of fish, wildlife and plants, the preservation of open space, outdoor recreation by the general public, sustainable forestry, agricultural uses, and historic values. PG&E will protect these beneficial public values associated with the Watershed Lands and Carizzo Plains from uses that would conflict with their conservation. PG&E recognizes that such lands are important to maintaining the quality of life of local communities and all the people of California in many ways, and it is PG&E's intention to protect and preserve the beneficial public values of these lands under the terms of any agreements concerning their future ownership or management.

PG&E Environmental Enhancement Corporation will develop a plan for protection of these lands for the benefit of the citizens of California. Protecting such lands will be accomplished through either (1) PG&E's donation of conservation easements to one or more public agencies or qualified conservation organizations consistent with these objectives, or (2) PG&E's donation of lands in fee to one or more public entities or qualified conservation organizations, whose ownership would be consistent with these conservation objectives.

### COMMITMENTS

1. PG&E Shall Place Permanent Conservation Easements on or Donate Watershed Lands: The Watershed Lands and Carizzo Plains shall (1) be subject to permanent conservation easements restricting development of the lands so as to protect and preserve their beneficial public values, and/or (2) be donated in fee simple to one or more public entities or qualified non-profit conservation organizations, whose ownership will ensure the protection of these beneficial public values. PG&E will not be expected to make fee simple donations of Watershed Lands that contain PG&E's hydroelectric project features. In instances where PG&E has donated land in fee, some may be sold to private entities subject to conservation easements and others, without significant public interest value, may be sold to private entities with few or no restrictions.

   The conservation easements shall provide for the preservation of land areas for the protection of the natural habitat of fish, wildlife and plants, the preservation of open space, outdoor recreation by the general public, sustainable forestry, agricultural uses, and historic values and, shall prevent any other uses that will significantly impair or interfere with those values. Conservation easements on the Watershed Lands will include an express reservation of a right for continued operation and maintenance of hydroelectric facilities and associated water delivery facilities, including project replacements and improvements required to meet existing and future water delivery requirements for power generation and consumptive water use by existing users, compliance with any FERC license, FERC license renewal or other regulatory requirements. In addition, easements will honor existing agreements for economic uses, including consumptive water deliveries. The conservation easements shall be donated to and managed by one or more non-profit conservation trustees, qualified conservation organizations or public agencies with the experience and expertise to fully and strictly implement the conservation easements.

2. Process For Development of the Conservation Easements and Land Donation Plan: PG&E will work with PG&E Environmental Enhancement Corporation and the Commission in the development and implementation of the conservation easements and land donation plan. PG&E Environmental Enhancement Corporation will recommend to PG&E (1) conservation objectives for the properties, including identification of conservation values, (2) criteria for ultimate disposition of the properties, (3) conservation easements guidelines, and (4) land disposition plans.

3. Reporting Responsibilities: PG&E Environmental Enhancement Corporation will prepare a report to the Commission within 18 months of the Effective Date describing the status of the conservation easement and land disposition plan. PG&E Environmental Enhancement Corporation will make the report available to the public upon request. Every two years following the first report, PG&E Environmental Enhancement Corporation will prepare a report to the Commission on the implementation of the conservation easement and land disposition plan.

**Exhibit B**

Expert Report and Direct Testimony of Ashutosh Bhagwat

Jt. Pl. 63

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UNITED STATES DISTRICT COURT

DISTRICT OF CALIFORNIA

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|---|---|
| In re<br><br>PACIFIC GAS AND ELECTRIC COMPANY, a California corporation,<br>Debtor.<br><br>Federal I.D. No. 94-0742640 | Case No. 01-30923 DM<br><br>Chapter 11 Case |

**EXPERT REPORT OF ASHUTOSH BHAGWAT**

## I. Introduction

I have been asked by outside counsel for the California Public Utilities Commission ("the Commission") to render an opinion as to whether the amounts offered to settle the case captioned *Pacific Gas and Electric Co.* v. *Loretta Lynch, et al.*, Case No. C-01-3023 - VRW (N.D. Cal.) pending in federal district court for the Northern District of California (Walker, T.) (the "Rate Recovery Litigation") pursuant to the Commission's and Official Committee of Unsecured Creditor's Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company (the "Joint Plan"), is fair and equitable. *See Martin*

v. *Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986); *see also* Bankruptcy Rule 9019.

I understand that the Joint Plan provides PG&E with revenues from a previously conditioned increase in rates (so-called "headroom") accumulated from June 2001 through to the effective date of the Joint Plan (January 31, 2003) in consideration for the proposed settlement of the Rate Recovery Litigation. *See* Plan Disclosure Statement at §§ III.E.1, VI.C.4; Reorganization Agreement at §§ 1.1(r), 2.2, 2.6. I further understand that this amount has been estimated at approximately $2.7 billion. *See* Commission Press Release at 3 (attached hereto as Exhibit 1).[1] I also understand that PG&E alleges in its complaint in the Rate Recovery Litigation that it suffered $9.2 billion in uncollected costs during the relevant time period. *See* Complaint at ¶ 43.[2] Thus, pursuant to the Joint Plan, PG&E will receive at least $2.7 billion to settle a claim of $9.2 billion. Even assuming the $9.2 billion figure to be accurate, based on consideration of the factors identified by the court in *Martin* v. *Kane*, 784 F.2d 1377, 1381 (9th Cir. 1986), and as discussed below, it is my opinion that the proposed settlement of PG&E's claims in the Rate Recovery Litigation for an amount not less than $2.7 billion is reasonable under the particular circumstances of the Rate Recovery Litigation.[3]

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[1] I also understand that the Joint Plan includes other forms of consideration, namely, that "the Commission will permit the Debtor to recover in rates the cost of the debt securities to be issued under the Plan, the proceeds of which are being used to repay a large portion of PG&E's indebtedness incurred during the energy crisis." *See* Plan Disclosure Statement at §§ III.E.1, IV.C.4; *see also* Reorganization Agreement at §§ 2.2, 2.6. Because this amount has not yet been precisely quantified, I have not included it here as part of my analysis, but since it would only increase the amount of the consideration to be paid to PG&E to settle the Rate Recovery Litigation, this factor would not alter my ultimate conclusion.

[2] This number may be overly generous in calculating the maximum undercollection recoverable by PG&E since I understand that PG&E's own TCBA reports filed with the Commission have reduced this number first to $7.8 billion as of July 31, 2001 and then to $6.7 billion as of February 28, 2002 (Long Motion to Dismiss Decl. at ¶ 37; Long Opp. to Pl. Sum. Judg. Decl. at ¶ 3 (attached hereto as Exhibits 6 and 7). In fact, the Court in the Rate Recovery Litigation found that PG&E itself claimed an undercollection of approximately $6.7 billion. *See* July 25, 2002 Order at 53 (dismissing summary judgment motions of all parties) ("July 25 Order") (attached hereto as Exhibit 2).

[3] In accordance with Section C(1) of the Order Re: Discovery Protocol and Scheduling, I will make myself available for deposition in San Francisco as requested by the parties and the Discovery Coordinator.

## II. Qualifications

I am a Professor of Law and the Associate Academic Dean at the University of California, Hastings College of the Law. Prior to joining the Hastings Faculty in 1994, I practiced as a regulatory and appellate lawyer at Sidley & Austin in Washington, D.C. After graduating from law school at the University of Chicago, I clerked first for Judge Richard A. Posner of the United States Court of Appeals for the Seventh Circuit, and then for Associate Justice Anthony M. Kennedy of the United States Supreme Court. My resume and a list of my publications is appended at Exhibit 3.

Constitutional Law and economic regulation, both of which are central to the Rate Recovery Litigation, are among my primary research and teaching areas. I teach courses in Regulated Industries and Constitutional Law that address many of the issues at issue in the Rate Recovery Litigation, including the filed rate doctrine and the Takings Clause. A syllabus for my course in Regulated Industries is attached at Exhibit 4.

In reaching my opinion I have reviewed the relevant pleadings, briefs, and opinions in the Rate Recovery Litigation as well as relevant documents filed in PG&E's bankruptcy proceedings. A list of the documents I have reviewed is appended at Exhibit 5.[4]

## III. Factual Background

A comprehensive summary of both the procedural and factual background in the Rate Recovery Litigation can be found in Judge Walker's July 25 Order denying summary judgment to all movants, a copy of which can be found at Exhibit 2.

## IV. Discussion

The Ninth Circuit, in *Martin v. Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986), explained that in determining whether a settlement is "fair and equitable" under Bankruptcy Rule 9019, a bankruptcy court must consider the following four factors: (1) the probability of success in the litigation; (2) the difficulties, if any, to be encountered in the

[4] My hourly rate in connection with my retention in this matter is $400.

matter of collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable views. Because factors 2 and 4 have no applicability to the instant case, I analyze only factors 1 and 3, *infra*.

**A. Probability of Success**

The most significant reason why the settlement amount proposed in the Joint Plan falls within the range of reasonable resolutions is because PG&E's claims in the Rate Recovery Litigation face substantial risks of failure. Based on my knowledge of evolving principles of policy and law in the area of regulated industries and on my review of the documents and pleadings in the litigation, it is my opinion that PG&E's claims face very substantial risks of failure on the merits, and that even if PG&E were able to make out a claim for relief, PG&E's recovery is likely to be very substantially less than the amount it requests in its complaint.

**1. Summary**

There are several reasons why PG&E's claims in the Rate Recovery Litigation face substantial risks on the merits and in recovery of any award. To summarize briefly, there remain significant doubts regarding whether courts will choose to apply the filed rate doctrine (including the extension of the filed rate doctrine announced in *Nantahala Power & Light Co.* v. *Thornburg*, 476 U.S. 953 (1986) ("*Nantahala*")), to the kinds of market-based tariffs which form the basis of PG&E's primary claims. More significantly, even if the filed rate doctrine and the rule of *Nantahala* are applied to market-based tariffs generally, there are very real doubts that *Nantahala*'s preemption rule applies and/or was violated in the context of the regulatory regime in California of which PG&E complains, where federally regulated wholesale rates were set using market mechanisms, and state regulated retail rates were *not* set using traditional cost-of-service regulation but rather were subject to an *ex ante* statutory freeze.

Indeed, PG&E's claim that *Nantahala* applies in this context seems to assume that federal law *guarantees* that PG&E will receive a profit on resales of electricity acquired at wholesale under all circumstances. However, neither the filed rate doctrine nor the preemption rule of *Nantahala* provide any such assurances. Rather, PG&E's claims in this regard are probably best understood as rooted in the Takings Clause of the Fifth Amendment (and the Due Process Clause of the Fourteenth Amendment, which makes the Takings Clause applicable to the states). However, modern Takings jurisprudence also does not provide utilities with any guarantee of profitability, especially in the deregulated environment existing in California. Rather, PG&E's Takings Clause claims are based on outmoded law from the era of *Lochner* v. *New York*, 198 U.S. 45 (1905) and *Smyth* v. *Ames*, 169 U.S. 466 (1898), which has since been thoroughly discredited.

Finally, even if PG&E were able to surmount all of these barriers and successfully assert a claim for relief on the merits, the dollar amount of any recovery it receives is likely to be very limited, and certainly far lower than the amounts PG&E seeks in its complaint, because any losses it suffered due to the gap between wholesale and retail electricity prices during the California energy crisis are likely to be offset against excess revenue earned by PG&E prior to the crisis, and against revenue earned by PG&E from other sources, including from selling electricity during the crisis.

I discuss each of the three major barriers facing PG&E in greater detail below.

**2. <u>Application of Filed Rate Doctrine to Market-Based Tariffs</u>**

The first substantial barrier PG&E faces in prevailing against the Commission in the Rate Recovery Litigation arises from doubts regarding whether the courts will choose to apply the filed rate doctrine and its offspring, the preemption rule adopted in *Nantahala*, to the sorts of market-based tariffs which form the basis for PG&E's primary claim for recovery. The filed rate doctrine is a venerable and long-established but nonetheless controversial rule of regulatory law which was adopted by the judiciary during an era of pervasive rate-of-return regulation. The key assumption underlying the filed rate doctrine was that regulated firms were required to file tariffs with agencies which explicitly stated *all* rates and terms of service imposed by that firm on customers. The filed rate doctrine then provided that such rates and terms stated in tariffs became the only legal rates that the firm could charge, or that customers could pay.

The Supreme Court, in its leading recent filed rate doctrine decisions, *MCI Telecommunications Corp.* v. *American Telephone and Telegraph Co.*, 512 U.S. 218, 230 (1994) and *Maislin Industries, U.S., Inc.* v. *Primary Steel, Inc.*, 497 U.S. 116 (1990), has indicated that the primary purposes of the tariffing requirement and the filed rate doctrine are to permit regulatory agencies to carry out their responsibilities to oversee the reasonableness of rates charged by regulated firms (and to maintain their exclusive jurisdiction over such rates), to provide notice to customers regarding rates charged, and most importantly, to ensure that regulated firms do not discriminate amongst customers. The market-based tariffs approved by Federal Energy Regulatory Commission ("FERC") which form the basis for PG&E's claims, however, do not significantly advance any of these policies. Such tariffs do not permit FERC to ensure that individual rates are reasonable, because such rates are never disclosed to FERC (and application of the filed rate doctrine in all of its manifestations is not necessary to maintain exclusive agency jurisdiction); such tariffs do not provide customers with notice regarding rates, except in the trivial sense of providing notice that rates will be set by the market (a form of notice which is, after all, available, to all customers in all industries, regardless of whether they are regulated or subject to tariffing requirements); and market-based tariffs provide absolutely no assurance against price discrimination, since they explicitly authorize charging different customers different prices based on current market conditions. As a consequence, and contrary to the very cursory suggestions in a recent FERC opinion, application of the filed-rate doctrine to market-based tariffs does not seem to advance any of the policies which lead to the creation of the doctrine in the first place.

On the other hand, there are very powerful arguments for *not* applying the filed rate doctrine to market based tariffs. The basic premise underlying that filed rate doctrine is that filed rates have been evaluated for reasonableness by a regulatory agency (or have been permitted to go into effect without evaluation), and therefore should be shielded from collateral attack. In the context of prices set by *markets*, on the other hand, the normal presumption is that the process by which such prices are set *must* be subject to generally applicable legal rules such as the laws of contract, fraud, and trade regulation. Otherwise, there can be no assurance that the market is functioning and that the resulting prices are the product of a free and fair competitive process. Application of the filed rate doctrine to market-based tariffs has the perverse effect of shielding the market mechanisms described therein from the normal rules governing markets, without advancing any of the policies which underlie the filed rate doctrine. There are therefore strong reasons to doubt whether the courts would choose to apply the filed rate doctrine – which is, after all, a judicial creation – to market-based tariffs. A decision by the courts not to apply the filed rate doctrine to market-based tariffs would be fatal to the crux of PG&E's claim in the Rate Recovery Litigation.[5]

### 3. Application of the *Nantahala* Preemption Rule

Second, even if the filed rate doctrine itself is applied to market-based tariffs, there remain very powerful reasons to doubt whether courts will hold that the *Nantahala* preemption rule, which is an extension of the filed rate doctrine, applies to the circumstances of the California energy market, where wholesale rates were set in a market and retail rates were *not* set pursuant to traditional, cost-of-service regulation. In *Nantahala*, the Supreme Court held that when engaged in cost-based ratemaking to establish retail rates, state regulatory agencies are constitutionally preempted from treating as unreasonable wholesale prices or other terms of wholesales of electricity which are contained in tariffs filed with FERC (which are therefore deemed reasonable and legal under the filed rate doctrine). That rule, while controversial, is now well-established. But it was in no way violated by the Commission's actions in California. At no point did the Commission deem *any* rates set in wholesale markets unreasonable, and at no

[5] While Judge Walker's July 25 Order determines that the filed rate doctrine does apply to market-based rates, I expect that this decision will be appealed and stands a good chance of being reversed. In fact, even Judge Walker notes that "no court has yet been asked to apply the filed rate doctrine to circumstances such as those at bar." Exhibit 2 at 40.

time did the Commission decline to grant PG&E a rate increase *because* it deemed wholesale prices unreasonable.

Rather, under the California deregulatory scheme implemented in 1998, FERC-regulated wholesale prices were set through a market mechanism, and retail prices were frozen at a specific level regardless of wholesale price movements. This system provided utilities the opportunity to earn very high profits if wholesale prices were below the frozen retail levels, but exposed them to risk of loss if wholesale prices rose; and it was supported by all relevant parties when adopted, including PG&E (unsurprisingly, because PG&E expected to, and did reap enormous profits in the two years preceding the Crisis as a result of those frozen rates). Thus a key fact necessary for a violation of the *Nantahala* preemption rule – state regulation setting retail prices based on a utility's costs, including wholesale acquisition costs – was missing in the California system. As a consequence, no California state entity was ever in the position of having to determine the reasonableness or unreasonableness of wholesale rates subject to FERC regulation.

The most that can be said is that during the California energy crisis the Commission (and the state legislature) declined to abandon frozen retail rates, and therefore forced PG&E to bear losses the risk of which it had accepted as the quid pro quo for the opportunity to earn high profits (which in a cost-based regulatory system would certainly have been deemed excessive). That PG&E, like most everyone else, did not expect this downside risk to materialize and was disappointed when it did is perhaps unfortunate, but such risks are inherent to operating in a partially deregulated environment, as PG&E agreed to do when it acceded to California's reforms.

For all of these reasons, the holding of *Nantahala* appears to have no application to the events in California, suggesting that PG&E's primary claim in the Rate Recovery Litigation faces very substantial downside risks. What PG&E appears to be arguing for in the litigation is for the courts to *extend* the *Nantahala* doctrine beyond its original scope, and apply it outside of the cost-based retail ratemaking to a deregulated, market environment. Such an extension would transform the rule of *Nantahala* from a prohibition against state decisionmaking which conflicts directly with federal law (a relatively straightforward application of preemption principles) to a guarantee of profitability for all utilities which purchase wholesale power under FERC-approved tariffs, no matter how those utilities are regulated. Extending *Nantahala* in this way would severely hamper the ability of states to experiment with market-oriented reforms in the electricity sector, since in effect PG&E's proposed rule would not only permit deregulated utilities to earn supracompetitive profits, but shield them from market-imposed losses. No market can function properly under such conditions. However, the overwhelming trend in regulatory law and policy over the past two and a half decades has been away from traditional, cost-based ratemaking and towards market-oriented reforms. Furthermore, the judiciary has in general been highly supportive of such reforms, and in certain instances (notably in the telecommunications and natural gas industries) has acted as a key catalyst for reform efforts. It is therefore my opinion that the courts are quite unlikely to adopt the extension of *Nantahala* proposed by PG&E.

Not only is PG&E's proposed extension of *Nantahala* inconsistent with the trend of regulatory policy and judicial decisionmaking in recent years, it is also inconsistent with the basic tenets of the Supreme Court's decision in *Nantahala* (and its primary progeny, *Mississippi Power & Light Co.* v. *Mississippi*, 487 U.S. 354 (1988)) as well as with the federal structure of electricity regulation. *Nanatahala* and *Mississippi Power & Light* simply hold that when engaged in retail ratemaking, a state regulatory commission may not deem unreasonable a wholesale rate (or other term of a wholesale transaction) deemed reasonable under federal law. As noted above, that is a relatively unproblematic application of general principles of constitutional preemption. PG&E, however, would transform this narrow holding into a broader principle that state law *must always* permit utilities which purchase wholesale power to earn profits when reselling that power. This profitability requirement, however, in no way flows from preemption principles. It also flies in the face of the basic assumption of our regulatory system that *states*, not the federal government, have primary responsibility for regulating intrastate, retail electricity sales, and may exercise their power however they wish, so long as they do not directly conflict with federal policy. For these reasons as well, it is my opinion that PG&E's proposed extension of *Nantahala* is unlikely to be adopted, an outcome that would again be fatal to PG&E's primary claim in the Rate Recovery Litigation.

Indeed, once PG&E's primary argument in the Rate Recovery Litigation is properly understood, it becomes clear that it is not premised on preemption principles at all. Rather, it is an argument for an *independent* constitutional rule assuring regulated utilities profitability. The only possible source for such a principle would have to be the Takings Clause of the Fifth Amendment (as enforced against the states through the Due Process Clause of the Fourteenth Amendment). And in fact, PG&E's preemption arguments rely on a case, *Board of Public Utility Commissioners* v. *New York Telephone Company*, 271 U.S. 23 (1926), which is not a preemption case at all, but rather is a case applying Takings and Substantive Due Process principles (and in addition, PG&E has made independent claims invoking the Takings Clause). PG&E's probability of successfully asserting a Takings Clause claim against the Commission is, however, extremely slim. There is simply no basis in modern takings jurisprudence for the principle that utilities are *entitled* to a profit under all circumstances as a matter of constitutional law. As noted above, such a principle would severely hamper any possibility of market-oriented reforms of traditional cost-based regulatory schemes, and it is inconceivable that modern courts would view the Takings Clause to impose such a burden on reform. Indeed, the overwhelming trend in Takings jurisprudence since the New Deal era (beginning with the leading case of *Federal Power Commission* v. *Hope Natural Gas*, 320 U.S. 591 (1944)) has been in the direction of deference towards regulators.

Even in the context of cost-of-service regulation, modern Takings jurisprudence does not guarantee profitability for utilities (it at most guarantees utilities the opportunity to be profitable, an opportunity that PG&E was not deprived of). In a deregulated and reformed environment such as that in California, it is extremely unlikely that modern courts would hold that the Takings Clause shields PG&E from economic risks that it knowingly undertook when

PG&E agreed to a statutory scheme creating floating, market-based wholesale rates and fixed retail rates. PG&E's arguments to the contrary rely upon jurisprudence from the 1920s which not only is inapposite (since at that time essentially all utilities were subject to cost-of-service regulation), but has also been thoroughly discredited in recent years along with all other aspects of the *Lochner* era Supreme Court's aggressive enforcement of property rights and a laissez-faire economic philosophy. In short, if reformulated as a Takings claim PG&E's arguments in the Rate Recovery Litigation face even greater obstacles to success than as preemption claims, and PG&E's independent claims under the Takings Clause face similarly substantial risks.[6]

4. **Problems with PG&E's Claims for Relief**

Finally, even if PG&E were able to successfully establish a claim for relief on the merits, there are substantial doubts whether PG&E could recover anything close to the $6-9 billion it is seeking. There are several substantial obstacles to PG&E's purported undercollection claims, which in combination suggest that any recovery by PG&E might well be worth less than (and is very unlikely to be worth significantly more than) the compensation provided in the Commission's proposed settlement. Because of this fact, and because of the substantial risks PG&E faces on the merits of its claims, the Commission's proposed settlement of the Rate Recovery Litigation is well within the range of reasonable outcomes.

The doubts regarding the scope of any possible recovery on PG&E's part relate closely to the most problematic aspects of PG&E's preemption claim on the merits. Under the preemption rule set forth in *Nantahala*, in setting retail rates state regulators may not decline a rate increase because they deem FERC-regulated wholesale prices paid by the utility to be unreasonable. However, state regulators remain free to reject rate increases, and even impose losses on utilities, on any *other* grounds not in conflict with federal regulation (such as decreases in other utility costs, or a conclusion that the utility acted imprudently). PG&E seeks to transform this rule into a requirement that whenever wholesale prices increase, state regulators

[6] For the same reasons, PG&E's substantive due process claim faces similarly substantial risks, since any substantive due process claim in this area would be governed by takings principles.

*must* increase retail rates to reflect the entire wholesale rate increase. As noted above, *Nantahala* does not establish any such requirement; but more fundamentally, such a requirement is entirely irrational and unworkable in the context of the California system where wholesale prices were market-based and changed *hourly* due to shifting supply and demand conditions. Obviously, retail rates could not move so often.

Recognizing this, PG&E proposes an arbitrary time period of one month as the relevant measuring period, suggesting that over the course of every *month*, retail prices must be adjusted to reflect wholesale expenses. However, PG&E fails to provide any defense of the one month accounting period it advocates, because of course it cannot – PG&E advocates a short period purely because such an approach would maximize its recovery. Nonetheless, some accounting period must be chosen if indeed *Nantahala* is understood to require PG&E to recover its wholesale costs in retail rates. But the only non-arbitrary accounting period available is the entire period that the rate freeze on PG&E's retail rates was in effect. Using the full period of the rate freeze as the relevant comparison period captures the fact that when PG&E accepted the retail rate freeze, it was balancing the opportunity to very high profits against the risk of significant losses, depending on wholesale price movements. Any shorter accounting period, which excludes periods of time when PG&E earned high profits, permits PG&E to retain the windfall it earned in the first two years of the rate freeze, while still being compensated for later losses, a result with no apparent rationale. Nor is there any obvious basis for choosing any accounting period shorter than the entire rate freeze.

As a consequence, it seems likely that even if PG&E's claims are accepted on the merits, the courts are likely to select a lengthy accounting period to determine uncompensated losses, probably the entire period of the rate freeze. It is my understanding based on declarations submitted by the Commission in the Rate Recovery Litigation that during the pre-crisis, rate-freeze period, PG&E earned in excess of $2.7 billion in headroom revenues alone, and that if all of PG&E's revenue over the rate-freeze period are counted, PG&E did not suffer any losses, and actually, on balance, earned a net profit totaling billions of dollars. (Long Sum. Judg. Reply

Decl. at ¶ 7, Ex. H) (attached hereto as Exhibit 9). If all such revenues were counted, this would prove fatal to PG&E's filed rate claim; in any event, even if the court were to not include all of the offsetting revenues noted by the defendants, even crediting a portion of those revenues would significantly diminish PG&E's total claims.

In addition to uncertainty about the relevant accounting period, PG&E also faces substantial barriers to recovery because of great uncertainty regarding the relevant revenue streams to be counted against wholesale expenses to determine the actual, uncompensated wholesale expenses which PG&E incurred during the period of the California energy crisis. PG&E's position is that *only* its retail revenues should be taken into account, but in my opinion it is exceedingly unlikely the courts will adopt this position. PG&E's position is based on isolated language in various judicial opinions. However, all of those opinions arose in traditional regulatory contexts where retail rates were set using traditional cost-of-service regulation, and where retail rates were the only significant source of revenue for utilities. In California during the relevant period, however, the circumstances were very different. PG&E and other utilities earned very significant revenues from sources other than retail charges, including notably revenues from bonds issued at the beginning of the California restructuring process, and revenues from electricity PG&E sold into wholesale markets before and during the crisis period. There does not appear to be any reason why such revenue should not be used to offset PG&E's wholesale procurement costs.

Regarding the revenue from generation in particular the argument in this regard is overwhelming. In traditional regulatory regimes, vertically integrated utilities sell power they generate directly to customers, and therefore retail revenues *are* primarily "generation" revenues (retail revenues in traditional systems can also include some revenues for resold power). In the reformed California system, PG&E and the other utilities no longer sold their internally generated power directly to customers, but rather sold it into wholesale markets, and then turned around and purchased the same power to resell to their customers. As a consequence, the utilities earned independent "generation" revenue which simply would not have existed in a traditional regulatory regime. There is therefore no reason why such revenue should not be available to offset PG&E's wholesale procurement costs; and indeed, to *not* count such revenue would permit PG&E to retain very high profits earned during the crisis period by selling power when wholesale prices were high, while at the same time charging future ratepayers for high wholesale costs during that period, despite the fact that a significant portion of those costs were paid by PG&E to itself (albeit indirectly through the PX and ISO).

Given all of these factors, it is likely that adjudicating courts will include substantial sources of revenue other than retail revenues in determining PG&E's actual undercollections of wholesale procurement costs during the crisis period; and it is my understanding based on declarations submitted by the Commission in the Rate Recovery Litigation that PG&E earned approximately $2.9 billion in revenue from rate reduction bonds, approximately $2.75 billion in pre-June 2000 "headroom," and *at least* $2.4 billion (but probably much more) in net-offsetting revenue from generation. *See* Long Support of Def. Sum. Judg. Decl. at ¶ 37(a); Long Sum. Judg. Reply Decl. at Ex. H (attached hereto as Exhibits 8 and 9).[7] As a consequence, when all such relevant revenue streams are taken into account, PG&E's undercollection (and consequent recovery) is substantially reduced or even eliminated.

* * *

For all of the reasons stated above, it is my opinion that PG&E faces substantial barriers to recovery under either its preemption or its Takings Clause claims, and that even if PG&E were able to establish a claim on the merits, PG&E faces a very substantial probability of recovering far less than it is seeking. In addition to its preemption and Takings claims, PG&E has also filed a claim under the Commerce Clause of Article I. PG&E itself does not appear to be pursuing this claim with any vigor, but in any event, in light of the fact that the Commission's actions do not appear in any way to *discriminate* against interstate commerce, PG&E's probability of success on its commerce clause claims is extremely low, and the addition of this

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[7] These calculations do not even include an additional sum of approximately $9 billion in other offsetting revenue identified by the Commission. *See* Long Sum. Judg. Reply Decl. at Ex. H (Exhibit 9 hereto).

claim does not materially improve PG&E's probability of success in the Rate Recovery Litigation. In addition, the Commission has also raised some affirmative defenses in that litigation, including a constitutional sovereign immunity defense (based on the Eleventh Amendment) and a statutory immunity defense (based on the Johnson Act). It is beyond the scope of this expert opinion to assess those defenses, but of course their existence further reduces PG&E's ultimate probability of success in the Rate Recovery Litigation.

**B. Litigation Complexity, Expense, Inconvenience and Delay**

The second important factor in determining whether a proposed settlement is fair and equitable is a consideration of the complexity of the litigation as well as the expense, inconvenience and delay necessarily attending it. *Martin* v. *Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986). Because discovery, trial, and appeal in the Rate Recovery Litigation will be expensive and could take years to complete, it is my opinion that these factors weigh heavily in favor of settlement.

The Rate Recovery Litigation was commenced by PG&E almost two years ago and is still at a relatively nascent stage. PG&E filed its original complaint against the defendants on November 8, 2000 in the Northern District of California. *See* Complaint against *PG&E* v. *Lynch, et al*, Case No. C-00-4128 (SBA) (N.D. Cal). That action was subsequently transferred to Judge Lew in the Central District of California, and then dismissed without prejudice on ripeness grounds.

On August 8, 2001, PG&E re-filed its complaint in the Northern District of California, claiming that the orders implicated in its complaint had become final under state law. On September 24, 2001, defendants moved to dismiss PG&E's complaint. On the same day The Utility Reform Network ("TURN"), a nonprofit organization, moved to intervene and to dismiss PG&E's complaint. On December 18, 2001, Judge Walker determined that PG&E's complaint was related to another action pending before him, and the Rate Recovery Litigation was reassigned to him.

After briefing and oral argument on the motions to dismiss was completed, the court subsequently determined that further development of the record was required and set a hearing date for summary judgment motions of May 24, 2002. *See* Court's July 25 Order at 3 (Exhibit 2). Subsequently, both defendants and TURN moved for summary judgment. PG&E responded to those motions and also moved for partial summary judgment. By order dated July 25, 2002, defendants', TURN's and PG&E's motions were all denied.

On September 4, 2002, defendants made an interlocutory appeal of, *inter alia*, the court's denial of its sovereign immunity defenses and moved for a stay of all proceedings pending that appeal. PG&E opposed the motion for stay, which is currently *sub judice*.

Despite being almost two years old, the Rate Recovery Litigation is far from over. Even if that interlocutory appeal is denied and the Rate Recovery Litigation proceeds, the litigation is still at a very early stage. I understand that very little discovery has been conducted and much discovery remains to be done; indeed, the Court's Case Management Order permits approximately five additional months for discovery (including expert discovery), *see* Case Management Order at 2, and has scheduled the trial to commence on June 9, 2003. *Id.* Judge Walker's July 25, 2002 Order repeatedly notes his view that a number of disputed fact issues that must be resolved at trial, a fact which is likely to increase the extent and expense of discovery and trial. Moreover, this is likely a case in which the parties will retain experts, thus further increasing the expenses of the litigation. I also note that the court's decision to grant TURN's motion to intervene (also by its July 25 order) will only serve to increase the expense of discovery and the length of trial.

Regardless of the outcome at trial, the parties are likely to appeal. It is my view that the district court's July 25 order raises many appealable issues and that additional, appealable issues may well arise between now and the conclusion of trial. Appeal of these issues is likely to take many months if not years and require additional expense by the parties. Given the importance of this litigation to the parties, given the important legal issues at stake and the import of the precedent that the Rate Recovery Litigation will set, appeal will likely be sought and may well be granted by an *en banc* panel of the Ninth Circuit and/or the Supreme Court of the United States.

In sum, it is my opinion that the Rate Recovery Litigation will entail great expense, inconvenience and delay for PG&E. Final resolution of the case could take years and will most likely require millions of dollars in expense. This fact, coupled with the significant impediments to PG&E's likelihood of success in the litigation, leads me to the opinion that the proposed settlement is fair and equitable.

V. **Conclusion**

It is my opinion that given the fact that PG&E's probability of success in the Rate Recovery Litigation is quite limited, and given the expense, inconvenience and delay that is certain to attend any resolution of the litigation, the proposed settlement contemplated by the Joint Plan is reasonable under the circumstances.

Ashutosh Bhagwat — Date: Sept. 20, 2002

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UNITED STATES DISTRICT COURT

DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

| | |
|---|---|
| In re<br><br>PACIFIC GAS AND ELECTRIC COMPANY, a California corporation,<br>Debtor.<br><br>Federal I.D. No. 94-0742640 | Case No. 01-30923 DM<br><br>Chapter 11 Case |

**DIRECT EXPERT TESTIMONY OF ASHUTOSH BHAGWAT IN SUPPORT OF JOINT PLAN**

## I. QUALIFICATIONS

**Q: Please state your name, title and business address.**

A: My name is Ashutosh Bhagwat. I am a Professor of Law and the Associate Academic Dean at the University of California, Hastings College of the Law which is located at 200 McAllister Street in San Francisco, California.

**Q: Please summarize your professional qualifications.**

A: Prior to joining the Hastings Faculty in 1994, I practiced as a regulatory and appellate lawyer at Sidley & Austin in Washington, D.C. After graduating from law school at the University of Chicago, I clerked first for Judge Richard A. Posner of the United States Court of Appeals for the Seventh Circuit, and then for Associate Justice Anthony M. Kennedy of the United States Supreme Court. My resume and a list of my publications is appended at Exhibit 1.

Constitutional Law and economic regulation, both of which are central to the Rate Recovery Litigation, are among my primary research and teaching areas. I teach courses in Regulated Industries and Constitutional Law that address many of the issues at issue in the Rate Recovery Litigation, including the filed rate doctrine and the Takings Clause. A syllabus for my course in Regulated Industries is attached at Exhibit 2.

## II. PURPOSE OF TESTIMONY

**Q: What is the purpose of your testimony?**

A: I have been asked by outside counsel for the California Public Utilities Commission (which I will henceforth call "the Commission") to render an opinion as to whether the amounts offered to settle the case captioned *Pacific Gas and Electric Co.* v. *Loretta Lynch, et al.*, Case No. C-01-3023 -VRW (N.D. Cal.) pending in federal district court for the Northern District of California (Walker, J.) (which I will henceforth refer to as the "Rate Recovery Litigation") pursuant to the Commission's and Official Committee of Unsecured Creditor's Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company (the "Joint Plan"), is fair and equitable. *See Martin* v. *Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986); *see also* Bankruptcy Rule 9019.

I understand that the Joint Plan provides PG&E with revenues from a previously conditioned increase in rates (so-called "headroom") accumulated from June 2001 through the effective date of the Joint Plan (January 31, 2003) in consideration for the proposed settlement of the Rate Recovery Litigation. *See* Plan Disclosure Statement at §§ III.E.1, VI.C.4; Reorganization Agreement at §§ 1.1(r), 2.2, 2.6. I further understand that this amount has been estimated at approximately $2.7 billion. *See* Commission Press Release at 3 (attached hereto as Exhibit 3). I also understand that the Joint Plan includes other forms of consideration, namely, that "the Commission will permit the Debtor to recover in rates the cost of the debt securities to be issued under the Plan, the proceeds of which are being used to repay a large portion of PG&E's indebtedness incurred during the energy crisis." *See* Plan Disclosure Statement at §§ III.E.1, IV.C.4; *see also* Reorganization Agreement at §§ 2.2, 2.6. While this amount had not been qualified at the time I submitted my expert report (and thus was not relied on by me for purposes of my expert opinion at that time), I understand that this amount has been subsequently quantified at approximately $1.75 billion.

I also understand that PG&E alleges in its complaint in the Rate Recovery Litigation that it suffered $9.2 billion in uncollected costs during the relevant time period but that, elsewhere, that figure has been described as low as approximately $6 billion. *See* Complaint at ¶ 43.[1] Thus, pursuant to the Joint Plan, PG&E will receive anywhere between $2.7 billion and $4.45 billion to settle a claim of between approximately $6 and $9.2 billion. That brings the proposed settlement within a range of no less than 29 ¢ on the dollar (assuming at $2.7 billion settlement on $9.2 billion) and as much as 74 ¢ on the dollar (assuming a $4.45 billion settlement on $6 billion). Based on consideration of the factors identified by the court in *Martin* v. *Kane*, 784 F.2d 1377, 1381 (9th Cir. 1986), and as discussed below, it is my opinion that the proposed settlement of PG&E's claims in the Rate Recovery Litigation is within the range of reasonable outcomes.

**Q: Did you submit an expert report in conjunction with this matter?**

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[1] This $9.2 billion number may be overly generous in calculating the maximum undercollection recoverable by PG&E since I understand that PG&E's own TCBA reports filed with the Commission have reduced this number first to $7.8 billion as of July 31, 2001, then to $6.7 billion as of February 28, 2002, then to $5.98 billion as of March 31, 2002 (Long Motion to Dismiss Decl. at ¶ 37; Long Opp. to Pl. Sum. Judg. Decl. at ¶ 3; Long Sum. Judg. Reply Decl. at ¶ 13 (attached hereto as Exhibits 5, 6 and 8 respectively). In fact, the Court in the Rate Recovery Litigation found that PG&E itself claimed an undercollection of approximately $6.7 billion. *See* July 25, 2002 Order at 53 (dismissing summary judgment motions of all parties) ("July 25 Order") (attached hereto as Exhibit 4). In this case, PG&E'S Lead Director of Regulatory Relations, M. Christie McManus, gave testimony indicating that this amount is far below $9 billion. *See* McManus Deposition Transcript at 30-33.

A: Yes, that expert report was completed and served on September 20, 2002.

## III. FACTUAL BACKGROUND

**Q: What is the Rate Recovery Litigation, as described in your expert report?**

A: The so-called Rate Recovery Litigation is litigation initiated by PG&E in federal court. The case is entitled *Pacific Gas and Electric Co. v. Lynch et al.*, and is currently pending before Judge Vaughn Walker of the United States District Court for the Northern District of California. The primary relief PG&E is seeking in the litigation is an order requiring the Commission to permit PG&E to recover in future rates monies spent by PG&E during the California Electricity Crisis to purchase wholesale electricity. The primary claim advanced by PG&E in the litigation is premised on the so-called Filed Rate Doctrine, a principle of federal regulatory law; PG&E's claim is that as a matter of constitutional preemption, the Filed Rate Doctrine requires the Commission to permit PG&E to recover in retail rates money it spent to purchase wholesale electricity. PG&E is also claiming that the Commission's failure to permit such recovery would also violate a host of constitutional provisions, including the Takings Clause, the Commerce Clause, and the Due Process Clause. However, as I understand it, by far the greatest focus of the litigation is on the Filed Rate Doctrine/preemption claims, with some attention also provided to the Takings Clause.

**Q: What is the filed rate doctrine?**

A: The so-called "filed rate doctrine" is a rule of regulatory law created by the federal judiciary (in particular, by the Supreme Court) to effectuate the Court's views of appropriate regulatory policy. The doctrine has its roots in decisions of the Supreme Court from the first part of the twentieth century interpreting the Interstate Commerce Act, the first significant federal regulatory scheme targeted at the most important common carriers of that day, railroads. Since that time, the courts have extended the filed rate doctrine to a large array of other federal regulatory systems, including regulation of telecommunications, trucking, and energy.

The roots of the filed rate doctrine lie in the statutory requirement of tariffing, a requirement first established in federal law in the Interstate Commerce Act, and then repeated in numerous other regulatory statutes including the Communications Act of 1934 and the Federal Power Act. All of these statutes require that regulated firms – whether they be railroads, telecommunications carriers, or electricity sellers – must file with the relevant regulatory agency a tariff which describes the prices, terms, and conditions upon which the regulated firms offer to provide a regulated service to the public. At its core, the filed rate doctrine provides that when a regulated firm is subject to a tariffing requirement, it must provide service *only* at the tariffed price and on the terms set out in the tariff. Any deviation from those prices or terms for any customer constitutes a statutory violation, whether the terms are more or less favorable to the customer. Put differently, the filed rate doctrine provides that when a regulated firm is subject to a tariffing requirement, the terms of service provided in the tariff are the *only legal* terms upon which service may be provided. As a consequence, if for example a regulated firm charges a customer more than the tariffed price, the customer may sue to recover the overcharge – and concomitantly (if somewhat counter intuitively), if the regulated firm charges a customer less than the tariffed rate, the firm may then sue to recover the undercharge. By strictly enforcing this requirement that only tariffed rates be filed, the filed rate doctrine is said to advance the regulatory policies of preventing discrimination between customers of regulated firms, and of protecting regulatory agencies' primary jurisdiction to determine the legal rates which may be charged by regulated firms by evaluating their tariff filings.

**Q: Is that all that the filed rate doctrine requires – that only tariffed prices and terms of service be offered?**

A: No – otherwise the doctrine would have little relevance to events in California, since there is no claim that I am aware of that tariffs were deviated from during the electricity crisis. As I said, the original and primary application of the filed rate doctrine was to ensure that only tariffed prices may be charged. In later years, however, the courts (including again the Supreme Court) extended the reach of the doctrine by extrapolating from the idea that the price and terms stated in a tariff are the *only* legal terms of service a regulated firm may impose, or a customer of such a firm may obtain. Based on this, the courts determined that the filed rate doctrine preempts certain legal claims brought by customers under either state or federal law directed against regulated firms. In short, the filed rate doctrine has been held to preempt any claim which is directed at the legality of any price or term of service stated in a tariff. Thus most notoriously, the doctrine was held to prevent a price-fixing claim under the antitrust laws against defendants who were regulated firms, because the effect of imposing liability would be to undermine the legality of a price stated in a tariff, but such a price is presumptively legal. Similarly, state-law claims based on contract or tort law which challenge terms of a tariff have been held preempted by the filed rate doctrine. In all of these instances, the primary reasons to preempt such claims have been described as protecting agencies' jurisdiction, and even more significantly, preventing discrimination among customers (since if some customers recover money in such actions, they will in effect pay a lower price than other customers). These applications of the doctrine are said to follow logically from the strong assumption adopted by the Supreme Court that tariffed rates and terms are the *only* permissible terms of service, and may not be deviated from under any circumstances. However, these applications of the filed rate doctrine have not been uncontroversial, especially in recent years as deregulatory forces have swept through many previously regulated industries, and there has been recent academic commentary recommending that these aspects of the filed rate doctrine be abandoned.

The application of the filed rate doctrine to preempt private claims against regulated firms is not, however, the most controversial application of that rule. In 1986 in a case called *Nantahala Power and Light Company v. Thornburg* the Supreme Court extended the filed rate doctrine beyond the context of private claims directly challenging provisions of tariffs, to preempt even state regulatory proceedings which *indirectly* conflict with federally-filed tariffs.

**Q: What is the rule established by the Supreme Court in *Nantahala Power and Light Co. v. Thornburg*?**

A: In *Nantahala Power and Light* (and a successor case called *Mississippi Power & Light Co. v. Mississippi*) the Supreme Court was faced with challenges to state regulatory proceedings where state regulators were setting permissible retail prices for electricity for utilities who had purchased electricity at wholesale. This situation creates the potential for regulatory conflict because under current federal law, wholesales of electricity are generally subject to the jurisdiction of a federal regulatory agency, the Federal Energy Regulatory Commission or "FERC," and must be made pursuant to tariffs filed with FERC. Retail sales of electricity, however, remain primarily subject to state, not federal regulatory authority. In both *Nantahala* and *Mississippi Power & Light*, state regulators, in the course of setting retail rates, made assumptions about the utilities wholesale purchases of power which were inconsistent with terms of sale actually approved by FERC. In particular, in both cases the state regulators held that the utilities' actions in purchasing certain amounts of wholesale power under FERC-approved tariffs were unreasonable, and as a consequence the utilities were not permitted to fully pass on in retail prices the wholesale costs of power acquisition. In both cases the Supreme Court held that this action by state regulators was precisely parallel to a determinations that utilities' purchases under FERC-approved tariffs were at an unreasonable price (though in fact neither case actually involve state second-guessing of prices, it involved other terms of the sale). As a result, in both cases, the Supreme Court held that the state regulators' actions were preempted by the filed rate doctrine, and therefore violated the Supremacy Clause of the Constitution. The basis of this conclusion was that under the filed rate doctrine, any rate or term of service contained in a properly filed tariff was presumptively legal and reasonable. Therefore, state regulatory actions which found such rates or terms to be unreasonable were inconsistent with federal law and tended to interfere with federal policy.

It should be noted that the rule adopted in *Nantahala* is itself an extension of the basic filed rate doctrine. This is because the state regulators in *Nantahala* and *Mississippi* at no point required any wholesale sale of electricity subject to FERC regulation to be conducted on terms other than those contained in tariffs; nor did they provide any refunds to wholesale customers, thereby undermining tariffs. Instead, they set *retail* prices over which they had undoubted jurisdiction, but using reasoning which was inconsistent with FERC's conclusions. The Court concluded that state conclusions that federally-approved rates or terms were unreasonable thwarted federal policy, and so was impliedly preempted. This conclusion is defensible, but it is far from inevitable, and undoubtedly represents a quite aggressive extension of the filed rate doctrine.

## IV. DISCUSSION

**Q: What legal standard are you applying for purposes of your analysis?**

A: The Ninth Circuit, in *Martin v. Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986), explained that in determining whether a settlement is "fair and equitable" under Bankruptcy Rule 9019, a bankruptcy court must consider the following four factors: (1) the probability of success in the litigation; (2) the difficulties, if any, to be encountered in the matter of collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable views. Because factors 2 and 4 have no applicability to the instant case, I have analyzed only factors 1 and 3.

### A. Probability of Success

**Q: Could you briefly summarize why the proposed settlement amount falls within a range of reasonable resolutions to the Rate Recovery Litigation?**

A: The most significant reason why the settlement amount proposed in the Joint Plan falls within the range of reasonable resolutions is because PG&E's claims in the Rate Recovery Litigation face substantial risks of failure. Based on my knowledge of evolving principles of policy and law in the area of regulated industries and on my review of the documents and pleadings in the litigation, it is my opinion that PG&E's claims face very substantial risks of failure on the merits, and that even if PG&E were able to make out a claim for relief, PG&E's recovery is likely to be very substantially less than the amount it requests in its complaint.

There are several reasons why PG&E's claims in the Rate Recovery Litigation face substantial risks on the merits and in recovery of any award. To summarize briefly, there remain significant doubts regarding whether courts will choose to apply the filed rate doctrine (including the extension of the filed rate doctrine announced in *Nantahala Power & Light Co.* v. *Thornburg*, 476 U.S. 953 (1986) ("*Nantahala*")), to the kinds of market-based tariffs which form the basis of PG&E's primary claims. More significantly, even if the filed rate doctrine and the rule of *Nantahala* are applied to market-based tariffs generally, there are very real doubts that *Nantahala*'s preemption rule applies and/or was violated in the context of the regulatory regime in California of which PG&E complains, where federally regulated wholesale rates were set using market mechanisms, and state regulated retail rates were *not* set using traditional cost-of-service regulation but rather were subject to an *ex ante* statutory freeze.

Indeed, PG&E's claim that *Nantahala* applies in this context seems to assume that federal law *guarantees* that PG&E will receive a profit on resales of electricity acquired at wholesale under all circumstances. However, neither the filed rate doctrine nor the preemption rule of *Nantahala* provide any such assurances. Rather, PG&E's claims in this regard are probably best understood as rooted in the Takings Clause of the Fifth Amendment (and the Due Process Clause of the Fourteenth Amendment, which makes the Takings Clause applicable to the states). However, modern Takings jurisprudence also does not provide utilities with any guarantee of profitability, especially in the deregulated environment existing in California. Rather, PG&E's Takings Clause claims are based on outmoded law from the era of *Lochner* v. *New York*, 198 U.S. 45 (1905) and *Smyth* v. *Ames*, 169 U.S. 466 (1898), which has since been thoroughly discredited.

Finally, even if PG&E were able to surmount all of these barriers and successfully assert a claim for relief on the merits, the dollar amount of any recovery it receives is likely to be very limited, and almost certainly far lower than the amounts PG&E seeks in its complaint, because any losses it suffered due to the gap between wholesale and retail electricity prices during the California energy crisis are likely to be offset against excess revenue earned by PG&E

prior to the crisis, and against revenue earned by PG&E from other sources, including from selling electricity during the crisis.

1. Application of Filed Rate Doctrine to Market-Based Tariffs

**Q: Could you discuss in greater detail your conclusion that doubts exist as to whether the Filed Rate Doctrine applies in the instant context of market-based tariffs?**

A: Yes. The first substantial barrier PG&E faces in prevailing against the Commission in the Rate Recovery Litigation arises from doubts regarding whether the courts will choose to apply the filed rate doctrine and its offspring, the preemption rule adopted in *Nantahala*, to the sorts of market-based tariffs which form the basis for PG&E's primary claim for recovery. The filed rate doctrine is a venerable and long-established but nonetheless controversial rule of regulatory law which was adopted by the judiciary during an era of pervasive rate-of-return regulation. The key assumption underlying the filed rate doctrine was that regulated firms were required to file tariffs with agencies which explicitly stated *all* rates and terms of service imposed by that firm on customers. The filed rate doctrine then provided that such rates and terms stated in tariffs became the only legal rates that the firm could charge, or that customers could pay. The Supreme Court, in its leading recent filed rate doctrine decisions, *MCI Telecommunications Corp.* v. *American Telephone and Telegraph Co.*, 512 U.S. 218, 230 (1994) and *Maislin Industries, U.S., Inc.* v. *Primary Steel, Inc.*, 497 U.S. 116 (1990), has indicated that the primary purposes of the tariffing requirement and the filed rate doctrine are to permit regulatory agencies to carry out their responsibilities to oversee the reasonableness of rates charged by regulated firms (and to maintain their exclusive jurisdiction over such rates), to provide notice to customers regarding rates charged, and most importantly, to ensure that regulated firms do not discriminate amongst customers.

**Q: And why in your opinion does this suggest that the filed rate doctrine might not apply to market-based tariffs?**

A: Because the market-based tariffs approved by Federal Energy Regulatory Commission ("FERC"), which form the basis for PG&E's claims, do not significantly advance any of these policies. Such tariffs do not permit FERC to ensure that individual rates are reasonable, because such rates are never disclosed to FERC (and application of the filed rate doctrine in all of its manifestations is not necessary to maintain exclusive agency jurisdiction); such tariffs do not provide customers with notice regarding rates, except in the trivial sense of providing notice that rates will be set by the market (a form of notice which is, after all, available, to all customers in all industries, regardless of whether they are regulated or subject to tariffing requirements); and market-based tariffs provide absolutely no assurance against price discrimination, since they explicitly authorize charging different customers different prices based on current market conditions. As a consequence, and contrary to the very cursory suggestions in a recent FERC opinion, application of the filed-rate doctrine to market-based tariffs does not seem to advance any of the policies which lead to the creation of the doctrine in the first place.

On the other hand, there are very powerful arguments for *not* applying the filed rate doctrine to market based tariffs. The basic premise underlying that filed rate doctrine is that filed rates have been evaluated for reasonableness by a regulatory agency (or have been permitted to go into effect without evaluation), and therefore should be shielded from collateral attack. In the context of prices set by *markets*, on the other hand, the normal presumption is that the process by which such prices are set *must* be subject to generally applicable legal rules such as the laws of contract, fraud, and trade regulation. Otherwise, there can be no assurance that the market is functioning and that the resulting prices are the product of a free and fair competitive process. Application of the filed rate doctrine to market-based tariffs has the perverse effect of shielding the market mechanisms described therein from the normal rules governing markets, without advancing any of the policies which underlie the filed rate doctrine. There are therefore strong reasons to doubt whether the courts would choose to apply the filed rate doctrine – which is, after all, a judicial creation – to market-based tariffs. A decision by the courts not to apply the filed rate doctrine to market-based tariffs would be fatal to the crux of PG&E's claim in the Rate Recovery Litigation.[2]

2. Application of the *Nantahala* Preemption Rule

**Q: You testified that in addition to questions about whether the filed rate doctrine applies to market based rates, a separate question exists as to whether courts will hold that the *Nantahala* preemption rule applies in the instant setting, is that correct?**

A: Yes, it is my view that, even if the filed rate doctrine itself is applied to market-based tariffs, there remain very powerful reasons to doubt whether courts will hold that the *Nantahala* preemption rule, which is an extension of the filed rate doctrine, applies to the circumstances of the California energy market, where wholesale rates were set in a market and retail rates were *not* set pursuant to traditional, cost-of-service regulation. In *Nantahala,* the Supreme Court held that when engaged in cost-based ratemaking to establish retail rates, state regulatory agencies are constitutionally preempted from treating as unreasonable wholesale prices or other terms of wholesales of electricity which are contained in tariffs filed with FERC (which are therefore deemed reasonable and legal under the filed rate doctrine). That rule, while controversial, is now well-established. But it was in no way violated by the Commission's actions in California. At no point did the Commission deem *any* rates set in wholesale markets unreasonable, and at no time did the Commission decline to grant PG&E a rate increase *because* it deemed wholesale prices unreasonable.

**Q: Can you explain in more detail the basis for your opinion that the *Nantahala* preemption rule does not apply to the circumstances of the California energy market?**

A: Under the California deregulatory scheme implemented in 1998, FERC-regulated wholesale prices were set through a market mechanism, but during a transition period retail prices charged by incumbent utilities were frozen at a specific level regardless of wholesale price movements (after which period retail prices would move with wholesale prices). This

[2] While Judge Walker's July 25 Order determines that the filed rate doctrine does apply to market-based rates, I expect that this decision will be appealed and stands a good chance of being reversed. In fact, even Judge Walker notes that "no court has yet been asked to apply the filed rate doctrine to circumstances such as those at bar." Exhibit 4 at 40.

system provided utilities the opportunity to earn very high profits if wholesale prices were below the frozen retail levels, but exposed them to risk of loss if wholesale prices rose; and it was supported by all relevant parties when adopted, including PG&E (unsurprisingly, because PG&E expected to, and did reap enormous profits in the two years preceding the Crisis as a result of those frozen rates). Thus a key fact necessary for a violation of the *Nantahala* preemption rule – state regulation setting retail prices based on a utility's costs, including wholesale acquisition costs – was missing in the California system. As a consequence, no California state entity was ever in the position of having to determine the reasonableness or unreasonableness of wholesale rates subject to FERC regulation.

The most that can be said is that during the California energy crisis the Commission (and the state legislature) declined to abandon frozen retail rates, and therefore forced PG&E to bear losses the risk of which it had accepted as the quid pro quo for the opportunity to earn high profits (which in a cost-based regulatory system would certainly have been deemed excessive). That PG&E, like most everyone else, did not expect this downside risk to materialize and was disappointed when it did is perhaps unfortunate, but such risks are inherent to operating in a partially deregulated environment, as PG&E agreed to do when it acceded to California's reforms.

For all of these reasons, the holding of *Nantahala* appears to have no application to the events in California, suggesting that PG&E's primary claim in the Rate Recovery Litigation faces very substantial downside risks. What PG&E appears to be arguing for in the litigation is for the courts to *extend* the *Nantahala* doctrine beyond its original scope, and apply it outside of the cost-based retail ratemaking to a deregulated, market environment. Such an extension would transform the rule of *Nantahala* from a prohibition against state decisionmaking which conflicts directly with federal law (a relatively straightforward application of preemption principles) to a guarantee of profitability for all utilities which purchase wholesale power under FERC-approved tariffs, no matter how those utilities are regulated. Extending *Nantahala* in this way would, however, severely hamper the ability of states to experiment with market-oriented reforms in the electricity sector. This is because PG&E's proposed rule would permit deregulated utilities to earn supracompetitive profits, but would shield them completely from market-imposed losses. No market can function properly under such conditions, and no regulator subject to such a constraint could or would adopt market-based reforms. However, the overwhelming trend in regulatory law and policy over the past two and a half decades has been away from traditional, cost-based ratemaking and towards market-oriented reforms. Furthermore, the judiciary has in general been highly supportive of such reforms, and in certain instances (notably in the telecommunications and natural gas industries) has acted as a key catalyst for reform efforts. It is therefore my opinion that the courts are quite unlikely to adopt the extension of *Nantahala* proposed by PG&E.

**Q: Can you explain how the relevant case law and broader policies support your views on this issue?**

A: Yes, not only is PG&E's proposed extension of *Nantahala* inconsistent with the trend of regulatory policy and judicial decisionmaking in recent years, it is also inconsistent with the basic tenets of the Supreme Court's decision in *Nantahala* (and its primary progeny, *Mississippi Power & Light Co.* v. *Mississippi*, 487 U.S. 354 (1988)) as well as with the federal structure of electricity regulation. *Nanatahala* and *Mississippi Power & Light* simply hold that when engaged in retail ratemaking, a state regulatory commission may not deem unreasonable a wholesale rate (or other term of a wholesale transaction) deemed reasonable under federal law. As noted above, that is a relatively unproblematic application of general principles of constitutional preemption. PG&E, however, would transform this narrow holding into a broader principle that state law *must always* permit utilities which purchase wholesale power to earn profits when reselling that power. This profitability requirement, however, in no way flows from preemption principles. It also flies in the face of the basic assumption of our regulatory system that *states*, not the federal government, have primary responsibility for regulating intrastate, retail electricity sales, and may exercise their power however they wish, so long as they do not directly conflict with federal policy. For these reasons as well, it is my opinion that PG&E's

proposed extension of *Nantahala* is unlikely to be adopted, an outcome that would again be fatal to PG&E's primary claim in the Rate Recovery Litigation.

Indeed, once PG&E's primary argument in the Rate Recovery Litigation is properly understood, it becomes clear that it is not premised on preemption principles at all. Rather, it is an argument for an *independent* constitutional rule assuring regulated utilities profitability. The only possible source for such a principle would have to be the Takings Clause of the Fifth Amendment (as enforced against the states through the Due Process Clause of the Fourteenth Amendment). And in fact, PG&E's preemption arguments rely on a case, *Board of Public Utility Commissioners* v. *New York Telephone Company*, 271 U.S. 23 (1926), which is not a preemption case at all, but rather is a case applying Takings and Substantive Due Process principles (and in addition, PG&E has made independent claims invoking the Takings Clause).

**Q: What do you think is the probability of success of PG&E's claims if they are reformulated as Takings claims?**

A: PG&E's probability of successfully asserting a Takings Clause claim against the Commission is extremely slim. There is simply no basis in modern takings jurisprudence for the principle that utilities are *entitled* to a profit under all circumstances as a matter of constitutional law. As noted above, such a principle would severely hamper any possibility of market-oriented reforms of traditional cost-based regulatory schemes, and it is inconceivable that modern courts would view the Takings Clause to impose such a burden on reform. Indeed, the overwhelming trend in Takings jurisprudence since the New Deal era (beginning with the leading case of *Federal Power Commission* v. *Hope Natural Gas*, 320 U.S. 591 (1944)) has been in the direction of deference towards regulators.

Even in the context of cost-of-service regulation, modern Takings jurisprudence does not guarantee profitability for utilities (it at most guarantees utilities the opportunity to be profitable, an opportunity that PG&E was not deprived of). In a deregulated and reformed environment such as that in California, it is extremely unlikely that modern courts would hold that the Takings Clause shields PG&E from economic risks that it knowingly undertook when

PG&E agreed to a statutory scheme creating floating, market-based wholesale rates and fixed retail rates. PG&E's arguments to the contrary rely upon jurisprudence from the 1920s which not only is inapposite (since at that time essentially all utilities were subject to cost-of-service regulation), but has also been thoroughly discredited in recent years along with all other aspects of the *Lochner* era Supreme Court's aggressive enforcement of property rights and a laissez-faire economic philosophy. In short, if reformulated as a Takings claim PG&E's arguments in the Rate Recovery Litigation face even greater obstacles to success than as preemption claims, and PG&E's independent claims under the Takings Clause face similarly substantial risks.[3]

3. Problems with PG&E's Claim for Relief

**Q: Even if you assumed PG&E were able to establish a claim for relief on the merits, what is your opinion concerning PG&E's level of recovery?**

A: Even if PG&E were able to successfully establish a claim for relief on the merits, there are substantial doubts whether PG&E could recover anything close to the between $6 and $9 billion it is seeking. There are several substantial obstacles to PG&E's purported undercollection claims, which in combination suggest that any recovery by PG&E might well be worth less than (and is very unlikely to be worth significantly more than) the compensation provided in the Commission's proposed settlement. Because of this fact, and because of the substantial risks PG&E faces on the merits of its claims, the Commission's proposed settlement of the Rate Recovery Litigation is well within the range of reasonable outcomes.

**Q: What is the basis for your opinion?**

A: The doubts regarding the scope of any possible recovery on PG&E's part relate closely to the most problematic aspects of PG&E's preemption claim on the merits. Under the preemption rule set forth in *Nantahala*, in setting retail rates state regulators may not decline a rate increase because they deem FERC-regulated wholesale prices paid by the utility to be unreasonable. However, state regulators remain free to reject rate increases, and even impose

[3] For the same reasons, PG&E's substantive due process claim faces similarly substantial risks, since any substantive due process claim in this area would be governed by takings principles.

losses on utilities, on any *other* grounds not in conflict with federal regulation (such as decreases in other utility costs, or a conclusion that the utility acted imprudently). PG&E seeks to transform this rule into a requirement that whenever wholesale prices increase, state regulators *must* increase retail rates to reflect the entire wholesale rate increase. As noted above, *Nantahala* does not establish any such requirement; but more fundamentally, such a requirement is entirely irrational and unworkable in the context of the California system where wholesale prices were market-based and changed *hourly* due to shifting supply and demand conditions. Obviously, retail rates could not move so often.

Recognizing this, PG&E proposes an arbitrary time period of one month as the relevant measuring period, suggesting that over the course of every *month*, retail prices must be adjusted to reflect wholesale expenses. However, PG&E fails to provide any defense of the one month accounting period it advocates, because of course it cannot – PG&E advocates a short period purely because such an approach would maximize its recovery. Nonetheless, some accounting period must be chosen if indeed *Nantahala* is understood to require PG&E to recover its wholesale costs in retail rates. But the only non-arbitrary accounting period available is the entire transition period during which the rate freeze on PG&E's retail rates was to have been in effect. Using the full transition period as the relevant comparison period captures the fact that when PG&E accepted the retail rate freeze, it was balancing the opportunity to very high profits against the risk of significant losses, depending on wholesale price movements. Any shorter accounting period, which excludes periods of time when PG&E earned high profits, permits PG&E to retain the large sums of money it earned in the first two years of the transition period, while still being compensated for later losses, a result with no apparent rationale. Nor is there any obvious basis for choosing any accounting period shorter than the entire transition period.

As a consequence, it seems likely that even if PG&E's claims are accepted on the merits, the courts are likely to select a lengthy accounting period to determine uncompensated losses, probably the entire transition period. It is my understanding based on declarations submitted by the Commission in the Rate Recovery Litigation that during the pre-crisis period, PG&E earned in excess of $2.7 billion in headroom revenues alone,[4] and that if all of PG&E's revenue over the transition period are counted, PG&E did not suffer any losses, and actually, on balance, earned a net profit totaling billions of dollars. (Long Sum. Judg. Reply Decl. at ¶ 7, Ex. H) (attached hereto as Exhibit 8). If all such revenues were counted, this would prove fatal to PG&E's filed rate claim; in any event, even if the court were to not include all of the offsetting revenues noted by the defendants, even crediting a portion of those revenues would significantly diminish PG&E's total claims.

**Q: In addition to uncertainty about the relevant accounting period, are there any other barriers to PG&E's recovery?**

A: Yes, in addition to uncertainty about the relevant accounting period, PG&E also faces substantial barriers to recovery because of great uncertainty regarding the relevant revenue streams to be counted against wholesale expenses to determine the actual, uncompensated wholesale expenses which PG&E incurred during the period of the California energy crisis. PG&E's position is that *only* its retail revenues should be taken into account, but in my opinion it is exceedingly unlikely the courts will adopt this position. PG&E's position is based on isolated language in various judicial opinions. However, all of those opinions arose in traditional regulatory contexts where retail rates were set using traditional cost-of-service regulation, and where retail rates were the only significant source of revenue for utilities. In California during the relevant period, however, the circumstances were very different. PG&E and other utilities earned very significant revenues from sources other than retail charges, including notably revenues from bonds issued at the beginning of the California restructuring process, and revenues from electricity PG&E sold into wholesale markets before and during the crisis period. There does not appear to be any reason why such revenue should not be used to offset PG&E's wholesale procurement costs.

[4] "Pre-crisis headroom" refers to headroom accumulated prior to June 2000, which is distinct from the post-June 2001 headroom that I referred to as part of the consideration given for the proposed settlement of the Rate Recovery Litigation.

Regarding the revenue from generation in particular the argument in this regard is overwhelming. In traditional regulatory regimes, vertically integrated utilities sell power they generate directly to customers, and therefore retail revenues *are* primarily "generation" revenues (retail revenues in traditional systems can also include some revenues for resold power). In the reformed California system, PG&E and the other utilities no longer sold their internally generated power directly to customers, but rather sold it into wholesale markets, and then turned around and purchased the same power to resell to their customers. As a consequence, the utilities earned independent "generation" revenue which simply would not have existed in a traditional regulatory regime. There is therefore no reason why such revenue should not be available to offset PG&E's wholesale procurement costs; and indeed, to *not* count such revenue would permit PG&E to retain very high profits earned during the crisis period by selling power when wholesale prices were high, while at the same time charging future ratepayers for high wholesale costs during that period, despite the fact that a significant portion of those costs were paid by PG&E to itself (albeit indirectly through the PX and ISO).

Given all of these factors, it is likely that adjudicating courts will include substantial sources of revenue other than retail revenues in determining PG&E's actual undercollections of wholesale procurement costs during the crisis period; and it is my understanding based on declarations submitted by the Commission in the Rate Recovery Litigation that PG&E earned approximately $2.9 billion in revenue from rate reduction bonds, approximately $2.75 billion in pre-June 2000 "headroom," and *at least* $2.4 billion (but probably much more) in net-offsetting revenue from generation. *See* Long Support of Def. Sum. Judg. Decl. at ¶ 37(a); Long Sum. Judg. Reply Decl. at Ex. H (attached hereto as Exhibits 7 and 8).[5] As a consequence, when all such relevant revenue streams are taken into account, PG&E's undercollection (and consequent recovery) is substantially reduced or even eliminated.

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[5] These calculations do not even include an additional sum of approximately $9 billion in other offsetting revenue identified by the Commission. *See* Long Sum. Judg. Reply Decl. at Ex. H (Exhibit 8 hereto).

For all of the reasons stated above, it is my opinion that PG&E faces substantial barriers to recovery under either its preemption or its Takings Clause claims, and that even if PG&E were able to establish a claim on the merits, PG&E faces a very substantial probability of recovering far less than it is seeking.

**Q: Has PG&E asserted any other claims in the Rate Recovery Litigation?**

A: Yes, in addition to its preemption and Takings claims, PG&E has also filed a claim under the Commerce Clause of Article I. PG&E itself does not appear to be pursuing this claim with any vigor, but in any event, in light of the fact that the Commission's actions do not appear in any way to *discriminate* against interstate commerce, PG&E's probability of success on its commerce clause claims is extremely low, and the addition of this claim does not materially improve PG&E's probability of success in the Rate Recovery Litigation. In addition, the Commission has also raised some affirmative defenses in that litigation, including a constitutional sovereign immunity defense (based on the Eleventh Amendment) and a statutory immunity defense (based on the Johnson Act). It is beyond the scope of my expert opinion to assess those defenses, but of course their existence further reduces PG&E's ultimate probability of success in the Rate Recovery Litigation.

B. Litigation Complexity, Expenses, Inconvenience and Delay

**Q: Could you please summarize your views concerning the second factor you considered in determining whether a proposed settlement is fair and equitable?**

A: The second important factor in determining whether a proposed settlement is fair and equitable is a consideration of the complexity of the litigation as well as the expense, inconvenience and delay necessarily attending it. *Martin* v. *Kane (In re A&C Properties)*, 784 F.2d 1377, 1381 (9th Cir. 1986). Because discovery, trial, and appeal in the Rate Recovery Litigation will be expensive and could take years to complete, it is my opinion that these factors weigh heavily in favor of settlement.

**Q: Could you please summarize the procedural history of the Rate Recovery Litigation as it relates to your analysis of this issue?**

A: The Rate Recovery Litigation was commenced by PG&E almost two years ago and is still at a relatively nascent stage. PG&E filed its original complaint against the defendants on November 8, 2000 in the Northern District of California. *See* Complaint against *PG&E* v. *Lynch, et al*, Case No. C-00-4128 (SBA) (N.D. Cal). That action was subsequently transferred to Judge Lew in the Central District of California, and then dismissed without prejudice on ripeness grounds.

On August 8, 2001, PG&E re-filed its complaint in the Northern District of California, claiming that the orders implicated in its complaint had become final under state law. On September 24, 2001, defendants moved to dismiss PG&E's complaint. On the same day The Utility Reform Network ("TURN"), a nonprofit organization, moved to intervene and to dismiss PG&E's complaint. On December 18, 2001, Judge Walker determined that PG&E's complaint was related to another action pending before him, and the Rate Recovery Litigation was reassigned to him.

After briefing and oral argument on the motions to dismiss was completed, the court subsequently determined that further development of the record was required and set a hearing date for summary judgment motions of May 24, 2002. *See* Court's July 25 Order at 3 (Exhibit 4). Subsequently, both defendants and TURN moved for summary judgment. PG&E responded to those motions and also moved for partial summary judgment. By order dated July 25, 2002, defendants', TURN's and PG&E's motions were all denied.

On September 4, 2002, defendants made an interlocutory appeal of, *inter alia*, the court's denial of its sovereign immunity defenses and moved for a stay of all proceedings pending that appeal. PG&E opposed the motion for stay, and the Commission's motion was denied by the district court on October 18, 2002; I understand that on October 23, the Commission filed an urgent motion with the Ninth Circuit asking it to grant a stay of proceedings in the district court and requested decision by November 22. Briefing on the interlocutory appeal has yet to be completed.

**Q: Given the history and the procedural posture of this case, what is your view concerning the complexity of the Rate Recovery Litigation as well as the expense inconvenience and delay attending it?**

A: First, I would note that despite being almost two years old, the Rate Recovery Litigation is far from over. Even if the interlocutory appeal (based on sovereign immunity) is denied and the Rate Recovery Litigation proceeds, the litigation is still at a very early stage. I understand that discovery had been stayed for months while the parties' motions were briefed and decided, and such discovery has only resumed on October 18; and I understand that a great deal of discovery remains to be done (including expert discovery). Indeed, the trial is not scheduled to commence until June 9, 2003. *See* Case Management Order at 2. *Id.* Moreover, Judge Walker's July 25, 2002 Order repeatedly notes his view that a number of disputed fact issues must be resolved at trial, a fact which is likely to increase the extent and expense of discovery and trial. Further, this is likely a case in which the parties will retain experts, thus further increasing the expenses of the litigation. I also note that the court's decision to grant TURN's motion to intervene (also by its July 25 order) will only serve to increase the expense of discovery and the length of trial.

Regardless of the outcome at trial, the parties are likely to appeal. It is my view that the district court's July 25 order raises many appealable issues and that additional, appealable issues may well arise between now and the conclusion of trial. Appeal of these issues is likely to take many months if not years and require additional expense by the parties. Given the importance of this litigation to the parties, given the important legal issues at stake and the import of the precedent that the Rate Recovery Litigation will set, appeal will likely be sought and may well be granted by an *en banc* panel of the Ninth Circuit and/or the Supreme Court of the United States.

In sum, it is my opinion that the Rate Recovery Litigation will entail great expense, inconvenience and delay for PG&E. Final resolution of the case could take years and will most likely require millions of dollars in expense. This fact, coupled with the significant impediments to PG&E's likelihood of success in the litigation, leads me to the opinion that the proposed settlement is fair and equitable.

## V. CONCLUSION

**Q: Please summarize your overall expert opinion reached in conjunction with this case.**

A: It is my opinion that given the fact that PG&E's probability of success in the Rate Recovery Litigation is quite limited, and given the expense, inconvenience and delay that is certain to attend any resolution of the litigation, the proposed settlement contemplated by the Joint Plan is reasonable under the circumstances.

**Q: Does this conclude your testimony?**

A: Yes, it does.

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UNITED STATES DISTRICT COURT

DISTRICT OF CALIFORNIA

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| In re<br><br>PACIFIC GAS AND ELECTRIC COMPANY, a California corporation,<br><br>Debtor.<br><br>Federal I.D. No. 94-0742640 | Case No. 01-30923 DM<br><br>Chapter 11 Case |

**AFFIDAVIT OF ASHUTOSH BHAGWAT**

I, the undersigned, being duly sworn, depose and say that the foregoing is the testimony of the undersigned, and that such Direct Testimony and the exhibits sponsored by me to the best of my knowledge, information and belief, are true, correct, accurate and complete, and I hereby adopt said testimony as if given by me in court, under oath.

A.G. Bhagwat

Ashutosh Bhagwat

Subscribed and sworn to before me,
this 31st day of October, 2002.

Cindy Philapil

Notary Public

CINDY PHILAPIL
COMM. 1245971
NOTARY PUBLIC - CALIFORNIA
SAN FRANCISCO COUNTY
My Comm. Expires Dec. 17, 2003

## Exhibit C

Excerpts from the November 25, 2002 Transcript of Proceedings Before the Honorable Dennis Montali

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

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| In Re: | ) | Case No. 01-30923-DM |
| | ) | |
| PACIFIC GAS AND ELECTRIC COMPANY, | ) | San Francisco, California<br>Monday, November 25, 2002<br>9:30 a.m. |
| Debtor. | ) | |
| | ) | Chapter 11 |
| | ) | |
| | | Confirmation Hearing<br>Day 6 |

TRANSCRIPT OF PROCEEDINGS
BEFORE THE HONORABLE DENNIS MONTALI
UNITED STATES BANKRUPTCY JUDGE

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Proceedings recorded by electronic digital sound recording.
Transcript produced by transcription service.

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WITNESS INDEX



LEGEND: D = Diamond
E = Engel
K = Kaplan
N = Neal
S = Schenker

EXHIBIT INDEX

SAN FRANCISCO, CALIFORNIA, NOVEMBER 25, 2002, 9:30 A.M.

(Call to Order of the Court.)

THE COURT: I told you when we concluded our discussions on Friday I would do my best to dispose of the motion that Mr. Neal made on Thursday. It kept me busy over the weekend. I am prepared to give you a ruling on the motion.

So the following is my ruling on the oral motion of counsel for Pacific Gas and Electric Company, the debtor following completion of the presentation of the case in chief by the California Public Utilities Commission and the official committee of creditors regarding their second amended plan of reorganization, Exhibit 104, which I will refer to as the plan.

An objection to confirmation of a Chapter 11 plan is a contested matter under Bankruptcy Rule 9014, and that rule incorporates Bankruptcy Rule 7052, which in turn adopts verbatim the FRCP 52.

Thus the Court may use FRCP 52(c) to dispose of the matter if the party with the burden of going forward fails to establish in its case in chief its entitlement to relief.

The rule provides in part that if during a trial without a jury a party has been fully heard on an issue and the Court finds against that party on that issue, the Court may enter judgment as a matter of law.

For the following reasons, I have decided to deny the motion. I do not intend to issue a written order. If and when it is appropriate to do so, I will set forth in writing and in more detail the rationale of my decision which I will now summarize.

Three discrete arguments have been presented by the debtor in support of its motion. First it contends that as matter of fact, the CPUC and the OCC, the joint plan proponents, have not shown that the plan is financially feasible as required by Bankruptcy Code Section 1129(a)(11).

Counsel for debtor points to conditions that have not been met in the highly confident letter from UBS Warburg and several conditions that must be satisfied before Standard & Poor's issues indicative ratings for the debt and preferred stock to be issued under the plan.

Second, the debtor contends that evidence justifying the so-called settlement of the filed rate litigation is insufficient to satisfy the standards for settlements under Rule 9019 and that there has not been any evaluation of the litigation purportedly being settled and the claims being released.

Finally, the debtor contends that as a matter of law the reorganization agreement, Exhibit 4 to the plan, cannot be entered into by the CPUC because to do so would cause it to violate California law.

If California law is violated, then Bankruptcy Code Section 1129(a)(3) would preclude confirmation. That section also requires a plan to be proposed in good faith. But since there has been no contention on this motion that the plan has not been proposed in good faith and that I should deny confirmation on that alternative ground, I will consider only the violation of law portion of that section of the Bankruptcy Code.

Beginning with the financial feasibility contentions, I am satisfied that the joint plan proponents have carried their burden to establish a prima facie case of financial feasibility, even though there remains several conditions the joint plan proponents must satisfy before the plan can become effective.

As the Court discussed during oral argument on the motion, it is not uncommon to issue an order confirming a plan if it is likely that certain conditions will be satisfied later.

I cannot say on the evidence presented to date that the plan could not become effective in the near future. Because on the -- excuse me -- based on the evidence currently before the Court, it seems that the conditions in the UBS Warburg letter and the Standard & Poor’s -- excuse me -- the UBS Warburg and Standard & Poor letters could be satisfied with more time and after more information was received by the joint plan proponents and their advisors.

This is not inconsistent with what is plainly contemplated in Section 7.6 and Section 8.2(b) of the plan.

So to at present, no evidence forecloses the joint plan proponents from obtaining investment grade ratings for the plan -- securities rating from Moody's.

Finally, separately, as I will note in a moment, some changes do need to be made to the reorganization agreement, but that is not dispositive or just not -- those necessary changes do not require that the motion be granted.

Sometime later in these proceedings, depending upon the outcome of the current phase of the confirmation trial and perhaps later as part of the trial on PG&E's plan, I may need to address with counsel the procedure for following up on all pre-effective date conditions in order to assess the interval between any confirmation decision and any effective date.

I want to stress that my statement that the joint plan proponents have made a prima facie case in no way constitutes a finding of feasibility. As soon as I conclude these remarks, we will begin the phase of the trial in which PG&E and other objectors will contest the evidence presented by the joint plan proponents in their case in chief.

As to the second contention, settlement of the filed rate case and related releases, it would not be appropriate to grant the motion at this time since a schedule for submission of briefs dealing with the so-called equity issues has been established and that matter has not yet been fully briefed or argued.

Apart from the briefing, the thrust of the debtor's argument is that the best interest test has not been satisfied since the filed rate litigation is disposed of for inadequate consideration.

That is part and parcel of the equity argument. It has not even been raised by any creditors who are objecting to confirmation, at least in the context of the extant motion.

We come therefore to the third issue presented, the question of whether the reorganization agreement is invalid because by entering into it, the CPUC may be abrogating its responsibilities to fix rates in the future, impermissibly ceding to this Court jurisdiction vested in the California state courts under PUC Code Section 1759 and improperly purporting to bind future Commissions.

I conclude that future Commissions would be bound as a matter of California law pursuant to Sections 5.1 through 5.3 of the reorganization agreement and as a matter of federal law even without Section 5.1 of the agreement.

PG&E contends that CPUC's execution of the reorganization agreement as part of confirmation of the plan is ultra vires because it violates CPUC code. In particular, PG&E contends that the plan violates Section 1708 and 723 because it binds future Commissions to take into account certain factors in setting future rates and locks those future Commissions into the plan and reorganization agreement.

As the United States Supreme Court explained in Larson v. Domestic and Foreign Commerce Corp., however, an ultra vires claim rests on the state officer's or agency's lack of delegated power.

A claim of error in the exercise of that power is therefore not sufficient.

Here CPUC acted within its authority under Public Utilities Code Section 701 which confers on the Commission expansive authority to do all things that are specifically designated in the Public Utilities Code or in addition thereto which are necessary and convenient in the supervision and regulation of every public utility in California.

I would note as was discussed during oral argument, I do not believe 701 is a license to disregard other specific provisions of the Public Utilities Code or California law that would contradict the broad power granted in 701.

The broad authority as recognized by the California Supreme Court in Consumers Lobby Against Monopolies v. Public Utilities Commission and authorizes the Commission to enter into contracts in order to effectuate the Commission's regulatory mission.

As noted in U.S. Ecology, Inc., v. California, the California Legislature need not expressly give an agency the power to make enforceable promises.  Administrative officials may exercise such additional powers as are necessary for the due and efficient administration powers expressly granted by statute.

The CPUC has the power to enter into the reorganization agreement with the OCC and to propose the plan which has that agreement as its centerpiece for implementation and which if confirmed becomes a contract to which the CPUC is a party.

Moreover no section of the California Public Utilities Code forbids the CPUC from entering into such contracts.  Instead certain provisions provide that future Commissions may rescind or modify orders or decisions of the present Commission -- 1708 -- or that future Commissions may override current rates or classifications if they determine them to be unjust or unlawful -- Section 728.

Here the reorganization agreement is not a quasi judicial or a quasi legislative decision or order of the CPUC subject to modification or rescission under Section 1708.

Rather any order confirming CPUC's plan shall be an independent order by this Federal Court which after intense scrutiny of and opportunity to be heard on the plan.

Section 1708 is not implicated or compromised.

Moreover the reorganization agreement does not set rates or classifications.  Section 728 is likewise inapplicable.

The CPUC plan -- excuse me -- the plan and the reorganization agreement do not violate the Public Utilities Code.

In support of its contention that the CPUC plan and reorganization agreement violates state law, PG&E relies heavily on what this Court and the parties have conveniently called the Diablo Canyon decision.

In Diablo Canyon, the CPUC states, The parties agree that we cannot bind future Commissions. And later it states, And we have specifically held that we cannot bind the actions of a future Commission.

And again thus, since the CPUC exercises legislative powers when it sets rates, it appears that any Commission decision which attempts to fix prices that are automatically incorporated into rates over the next 28 years would not bind the successor, end of quote.

Here the CPUC's reorganization agreement and the plan do not attempt to fix rates or set rates. It is not imposing a methodology on future rates, although it is establishing a floor of costs which should be recoverable as currently required by law in any event.

The most important distinction between this case and Diablo Canyon, however, pertains to the CPUC's status with respect to the contracts at issue.

In Diablo Canyon, the CPUC was not a contracting party to the settlement at issue.  Rather it was acting in its quasi judicial function in approving a settlement between the -- between PG&E and other parties.

Here, however, the CPUC is the contracting party, and it is receiving consideration, namely the cooperation and support of OCC, in an effort to defeat a plan which would severely limit the scope of the CPUC's present authority in exchange for its promises in return.

The Commission drew this distinction in its own decision of Southern California Edison, 215 PUR 4th 559, where it held that Diablo Canyon was not applicable to contracts in which it is a party as opposed to when you're just entering an order approving your contract between other parties.

Furthermore, unlike the Diablo Canyon decision, the CPUC plan does not and reorganization agreement do not predetermine rates.

The CPUC has the power to enter into contracts and to subject itself to federal jurisdiction, including a waiver of sovereign immunity.  Thus its voluntary sponsorship of the plan and its voluntary entry in to the reorganization agreement binds it and subjects it to this Court's jurisdiction.

The Ninth Circuit in Keith v. Volte (phonetic) and its prior decision in Washington v. Penwell (phonetic) make clear that Federal Courts may enter consent decrees as long as Government agencies do not violate state law in doing so.

The reorganization agreement is not a two-party consent decree in the classic sense, but it most definitely is consensual on the part of the CPUC. There is no violation of California law, and thus the federal cases that I cited would permit the Court to enter such an order approving that agreement.

Next, the Court is being asked to enforce the reorganization agreement. Nothing more. If I thought otherwise, I would agree that California law was being violated and for the reason just stated, could not approve the reorganization agreement.

But I see this Court's role as more limited than PG&E's counsel predicts. If the CPUC failed to establish rates to cover the securities as called for in Section 2.2(i) of the reorganization agreement, it would be in breach.

If the CPUC departed from its historic practice for recovery of prudently incurred costs, defined as recoverable costs in the agreement, it would be in breach.

If the CPUC failed to facilitate achieving and maintaining investment grade ratings, it would be in breach. Beyond that and other instances requiring enforcement of the agreement in this Court, I envision no intrusion into the domain of the state administrative and judicial procedures dealing with these matters of rates, regulation of utilities, and the like.

Any order confirming the plan should expressly and explicitly state that this Court is not undertaking to supplant the state administrative and judicial procedures that traditionally govern the affairs of the debtor as a public utility.

There are areas of concern about the adequacy of the reorganization agreement that I believe need to be corrected. I see a -- I believe I see a discrepancy between the definition of investment grade rating, triple B minus for Standard & Poor’s and B double A 3 for Moody's, compared with that level for senior secured debt in Warburg, but a lower rating for senior unsecured debt.

I also think it is necessary either to incorporate the essential terms of the plan securities into the agreement by reference or otherwise mention them and to provide specifically for the regulatory asset in the reorganization agreement, including an amortization schedule and the accounting requirements, for without these promises, Section 2.2(i) of the agreement may become unenforceable as a matter of contract law.

I expect counsel for the joint plan proponents to attend to these matters promptly, and I will be happy to discuss these points with them and other parties on the record, of course, in more detail at some appropriate time. This is not the appropriate time.

In any event, I believe the reorganization agreement would be enforceable even without Section 5.1 where the Commission recites that its entering into the agreement is binding on future Commissions. This is so because that section could be construed as nothing more than a recital of the legal consequences of this Court's approving that agreement assuming it ever does.

The reason is simple. An order of this Court confirming the plan and approving the reorganization agreement becomes the law of this case as a federal decree, and the CPUC now and in the future will be bound under principles of res judicata, law of the case, judicial estoppel, and similar doctrines.

Thus PUC Code Section 1708 is not implicated even by that provision.

Moreover even if 1708 were implicated, I am convinced by cases such as Louisiana Pacific, a state case, and TWA, a Ninth Circuit case, and Southern Cal Edison, a CPU decision that I mentioned distinguishes Diablo Canyon, that governmental units who have the power to enter into contracts and the duty to make rates may do either or both in proper circumstances and that lawful contracts will be enforced rather than trampled by subsequent rate changes.

Here the CPUC has the power to contract and it is not setting rates under the reorganization agreement, but is instead agreeing not to change the rules of the game so as to reassure the financial markets and to make the plan feasible.

Any rate making must occur as a separate matter. PUC Code Section 728 and 1708 are alive and well and will not be overruled or ignored by approval of the reorganization agreement.

I'll stress again that by denying this motion I'm making no determination of feasibility. I'm making no determination that the plan is confirmable. I am simply saying, based upon the evidence presented, there is insufficient basis for granting of the Rule 52 motion.

That's my decision. I think it's time to proceed with the PG&E case in chief in opposition to the second amended plan.

Mr. Neal.

MR. NEAL: Thank you, Your Honor. Mr. Schenker will call our first witness.

MR. SPEAKER: Your Honor, while he's getting set, could I just ask one housekeeping question.

THE COURT: Yes, sir.

MR. SPEAKER: At what portion of this process do the parties address the preference questions? That hasn't been clear to me.

THE COURT: Well, that's set for calendar on Wednesday at the hearing.

MR. SPEAKER: Yeah. So, but we're having things today. So I guess the question is --

THE COURT: We're having what today? We're having our trial today.

MR. SPEAKER: I understand, and I'm asking are -- I'm trying to figure out whether questions that would go to preference are appropriate in this phase or not.

THE COURT: Well, you mean questions to witnesses?

MR. SPEAKER: Yes.

THE COURT: Well, I guess I'm confused. We're going to hear from some experts this morning.

MR. SPEAKER: Right.

THE COURT: How would they be competent to talk about preferences?

MR. SPEAKER: Well, when I asked about the PG&E plan to one witness in the affirmative case of the CPUC, PG&E objected, and Your Honor sustained that objection on the notion that the PG&E case was coming up.

We have some witnesses that we will hear in today, tomorrow, who have spoken both to the CPUC plan and the PG&E plan, and I'm trying to figure out what questions are, you know, relevant and in bounds relative to the preferences as between the two plans with respect to a witness that had spoken to both of them.

Now we can address that in the second part, or we c

## Exhibit D

November 19, 2002 Letter From Gary Cohen to Standard & Poor's

November 19, 2002

Standard & Poor's
55 Water Street
38th Floor
New York, NY 10041

Dear Ladies and Gentlemen:

I am the General Counsel to the State of California Public Utilities Commission (the "Commission"). This opinion is being provided to you in connection with a request you have made in order to assist you in your consideration of the Plan of Reorganization for Pacific Gas and Electric Company proposed by the Commission with the Official Committee of Unsecured Creditors (the "Joint Plan").

You have requested my opinion as to whether the Commission has legal authority to enter into the proposed Reorganization Agreement contemplated by the Joint Plan (the "Reorganization Agreement"); whether the Reorganization Agreement will be enforceable against the Commission for the life of the securities expected to be offered under the Joint Plan; whether the Commission may waive sovereign immunity as required by the Reorganization Agreement; and, finally, in connection with the possible future assignment of certain Department of Water Resources ("DWR") contracts permitted by a generator to be assigned to PG&E, if the Commission required PG&E to take assignment of such contracts after determining that costs under these DWR Contracts were "just and reasonable", whether the Commission may subsequently change such a determination.

To date the Commission has authorized the filing of the Joint Plan. It is a condition to the effectiveness of the Joint Plan that the Commission will make a determination that the terms and conditions of the Joint Plan are "just and reasonable."

## Discussion

### Section 701

The Commission's power to enter into the Reorganization Agreement arises from the Commission's broad constitutional and statutory authority to regulate public utilities. *See generally* Cal. Const., art. XII, § 5 & 6; Cal. Pub. Util. Code §§ 451, et seq., 701, 761, 762; *People v. W. Air Lines, Inc.*, 42 Cal. 2d 621, 630 (1954); *Wood v. Public Utilities Comm'n*, 4 Cal. 3d 288, 294-295 (1971).

Section 701 of the Public Utilities Code provides: "The [C]ommission may supervise and regulate every public utility in the State and may do all things, *whether specifically designated in this part or in addition thereto*, which are necessary and convenient in the exercise of such power and jurisdiction." (Emphasis added.) In enacting this statutory provision, the Legislature exercised its plenary power to confer additional authority and jurisdiction upon the Commission. *See* Cal. Const., art. XII, § 5; *S. Cal. Gas Co. v. Pub. Utilities Comm'n*, 24 Cal. 3d 653, 657-658 (1979), *citing People v. W. Air Lines, Inc.*, 42 Cal. 2d at 634.

The courts have given section 701 a liberal interpretation. In *Consumers Lobby Against Monopolies v. Public Utilities Commission*, 25 Cal. 3d 891, 905-906 (1979), the California Supreme Court stated:

> Pursuant to this grant of power the Legislature enacted Public Utilities Code section 701, conferring on the commission expansive authority to "*do all things*, whether specifically designated in [the Public Utilities Act] *or addition thereto*, which are necessary and convenient" in the supervision and regulation of every public utility in California. (Italics added.) The commission's authority has been liberally construed. (*See, e.g., People v. Superior Court* (1965) 62 Cal. 2d 515 [42 Cal. Rptr. 849, 399 P.2d 385]; *People v. Western Air Lines, Inc.* (1954) *supra*, 42 Cal.2d 621; *Sale v. Railroad Comm'n* (1940) 15 Cal. 2d 612 [104 P.2d 38]; *Kern County Land Co. v. Railroad Comm'n.* (1934) 2 Cal.2d 29 [38 P.2d 401, 39 P.2d 402].) Additional powers and jurisdiction that the commission exercises, however, 'must be cognate and germane to the regulation of public utilities ....' ( *Morel v. Railroad Comm'n* (1938) 11 Cal.2d 488, 492 and cases cited; *accord Southern Cal. Gas Co. v. Public Utilities Comm'n.* (1979) 24 Cal.3d 653, 656 [156 Cal. Rptr. 733, 596 P.2d 1149]).

This broad authority authorizes the Commission to enter into contracts, including contracts that constrain the Commission's future conduct in order to effectuate the Commission's regulatory mission. The purpose of the Reorganization Agreement is to provide a mechanism whereby PG&E can be assured of recovering through its rates the monies necessary to assure payment of securities that the Joint Plan contemplates will be sold to provide PG&E with a means to exit from bankruptcy. This purpose is unquestionably "cognate and germane" to the regulation of public utilities within the meaning of the case law cited above.

Under California law, "the Legislature need not expressly give an agency the power to make enforceable promises. Administrative officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as may fairly be implied from the statute granting the powers. Thus, an administrative agency has the power to contract on a particular matter if this power may be fairly implied from the general statutory scheme." *U.S. Ecology, Inc. v. State of California,* 92 Cal. App. 4th 113, 132 (2001) (citations and internal quotation marks omitted). Section 701 not only grants the Commission broad regulatory powers, but also states that the Commission possesses these powers "whether specifically designated in this part or in addition thereto." Cal. Pub. Util. Code § 701. These powers clearly embrace the ability to enter into contracts, including contracts like the Reorganization Agreement. Indeed, the scope of section 701 is so broad that the passage of a more specific statutory provision authorizing the Commission to enter into contracts would have been redundant.

Moreover, the California courts have held that where a state commission has authority to enter into contracts, such a contract *cannot* be subsequently undone by Commission decision or opinion. In *Louisiana-Pacific Corp.* v. *Humboldt Bay Municipal Water District*, 137 Cal. App. 3d 152 (1982), for example, the California Court of Appeals held that the Humboldt Bay Municipal Water District (the "District") was estopped from setting rates for water purchases that conflicted with a prior contract entered into with appellants, the Louisana-Pacific Corporation and the Crown-Simpson Corporation. In the late 1950s and 1960s, the District had entered into a series of contracts with appellants setting the prices appellants would pay for water purchased from the District on a sliding scale until 1999. In 1977, the Board of Directors of the District determined that the existing contracts "constituted an invalid limitation on the power of the Board to set rates," *id.* at 155, and passed a resolution superseding the rate structure in the pre-existing contracts. The California Court of Appeals reversed the lower court's refusal to enter a declaratory judgment estopping the District from setting rates that deviated from those established by the contracts. The *Louisiana-Pacific* court explained:

> And where a municipality has both the power to contract as to rates and also the power to prescribe rates from time to time, if it exercises its power in contract, its power to regulate the rates during the period of the contract is thereby suspended, and the contract is binding.

*Id.* at 161 (citations omitted).

In *Trans World Airlines* v. *City and County of San Francisco,* 228 F.2d 473 (9th Cir. 1956) (applying California law), the Ninth Circuit reached a similar result. The Ninth Circuit ruled that the Public Utilities Commission of the City and County of San Francisco ("SF Commission") could not, through a resolution purporting to establish rates, obviate a valid contract already agreed to by the City of San Francisco ("City"). In 1942, the City entered into a 12-year lease agreement with T.W.A. In 1950, the SF Commission passed a resolution that fixed the charges for the facilities "at a figure higher than that set in the 1942 contract." *Id.* at 474. The court ruled that the City "has bound itself as to rates and charges. . . by entering into a valid contact" and, as such, the contract could not be "superseded by subsequent regulation . . . . " As the *T.W.A.* court explained:

> It has been held in numerous cases, however, that a state legislature unless prohibited by constitutional provision may authorize a municipal corporation to establish by an inviolable contract the rates to be charged by a public utility for a reasonable term of years, the effect of which is to suspend, during the life of the contract, the governmental power of the state or municipality to fix or regulate the rates.

*Id.* at 476-77 (citation omitted). *See also Air Cal, Inc.* v. *City and County of San Francisco*, 865 F.2d 1112 (9th Cir. 1989) (where city and airlines had pre-existing lease contract, San Francisco Airports Commission was properly enjoined from attempting to enforce ordinance that obviated contract).

The broad enabling language of the statutes at issue in *Louisiana-Pacific* and *T.W.A.* is directly analogous to the language of section 701. In *Louisiana-Pacific,* for example, the statute provided that the District had the ability to "make contracts, employ labor, *and do all acts necessary for the full exercise of its powers.*" *Louisiana-Pacific,* 137 Cal. App. 3d at 157 (emphasis added). Similarly, in the *T.W.A.* case, the relevant statute gave the City, "in connection with the erection or maintenance of . . . airports," the power "to enter into contracts . . . *and otherwise exercise such powers as may be required or convenient in the promotion of aeronautics . . . .*" *T.W.A.*, 228 F.2d at 475 (emphasis added).

Finally, *Santa Margarita Area Residents Together v. San Luis Obispo County Board of Supervisors*, 84 Cal. App. 4th 221, 233 (2000), demonstrates the breadth of the authority to contract conferred by California law on California governmental entities. That case concerned a county's ability to enter into a development plan with a developer. Appellants contended that this agreement, which they characterized as a zoning "freeze," constituted an impermissible relinquishment by the county of its regulatory and police power. The court disagreed:

> A governmental entity does not contract away its police power unless the contract amounts to the 'surrender' or 'abnegation' of a proper governmental function. (*Morrison Homes Corp. v. City of Pleasanton* (1976) 58 Cal. App. 3d 724, 734 [130 Cal. Rptr. 196].) The County concluded that the zoning freeze in the Agreement advances the public interest by preserving future options. This type of action by the County is more accurately described as a legitimate exercise of governmental police power in the public interest than as a surrender of police power to a special interest. (*Morrison Homes Corp. v. City of Pleasanton, supra*, 58 Cal. App. 3d at p. 734; see also *Housing Authority v. City of L.A.* (1952) 38 Cal. 2d 853, 868 [243 P.2d 515].)

For reasons already discussed, the Commission is exercising its police and regulatory powers to make sure that the reorganization of PG&E in bankruptcy court is consistent with the public interest. Confirmation of the Joint Plan also will ensure retention of the Commission's regulatory authority over PG&E as an integrated utility. The Commission may thus constrain its future regulatory conduct in keeping with these powers, and in furtherance of these objectives.

Specific Performance

Precisely because of the well-recognized distinction (discussed above) between governmental contract-making versus governmental legislative decisionmaking, courts have repeatedly allowed an action for specific performance or declaratory relief where a government agency attempted to take action that abrogated a pre-existing contractual obligation. *See Air Cal, Inc.* v. *City and County of San Francisco*, 865 F.2d 1112 (9th Cir. 1989) (affirmed district court's entry of declaratory order decreeing ordinance an invalid abrogation of pre-existing contract and permanently enjoining city from enforcement of ordinance "so long as the [contract is] in effect"); *Trans World Airlines* v. *City and County of San Francisco,* 228 F.2d 473 (9th Cir. 1956) (reversing district court's refusal to enter injunction seeking to enjoin threatened enforcement of ordinance, since ordinance abrogated pre-existing contractual obligations); *Louisiana-Pacific Corp.* v. *Humboldt Bay Municipal Water District*, 137 Cal. App. 3d 152 (1982) (reversing the lower court's refusal to enter a declaratory judgment estopping the District from setting rates different from those established by the contracts).[1]

Section 1708

I have concluded that section 1708 of the Public Utilities Code is fully consistent with the conclusions set forth above. Section 1708 states: "The Commission may at any time, upon notice to the parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it."

Section 1708 codifies the general principle that a legislative or quasi-legislative body is ordinarily able to repeal previously enacted or promulgated legal rules, and that a judicial or quasi-judicial body is ordinarily able to overrule its own precedents. Thus, a legislative or quasi-legislative body could not ordinarily enact or promulgate a

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1 Subject to Commission approval, it is proposed that the Reorganization Agreement be amended to include the following language: "Each party agrees and acknowledges that in the event of any breach of this Agreement, the other Party would be irreparably injured and could not be made whole by any remedy other than specific performance. It is accordingly agreed that each Party hereto (a) irrevocably waives, in any action seeking specific performance of any provision of this Agreement, the defense of adequacy of a remedy at law, and (b) shall be entitled, in the event of any breach of this Agreement, to compel specific performance by the breaching Party of its obligations under this Agreement without posting any bond."

rule, and provide in the rule that the rule could never be repealed. Similarly, a judicial or quasi-judicial body could not ordinarily issue a decision, and provide in the decision that the decision could never be overruled.

These basic principles, however, are entirely compatible with the quite distinct proposition that governmental entities generally may enter into contracts that constrain the governmental entity's future actions. In *United States v. Winstar Corp.*, 518 U.S. 839, 871-876 (1996), the Supreme Court recognized that notwithstanding the "centuries-old concept" that one legislature may not bind the legislative authority of subsequent legislatures, *id.* at 872 (*citing* Blackstone, Commentaries on the Laws of England 90 (1765)), the government may enter into a binding contract, regardless of subsequent legislative efforts to repudiate the contract. *Id.* at 876. The plaintiffs in *Winstar* sued the government for breach of contract after a congressional modification in the law barred the government from performing its contractual promise to the plaintiffs. The Court held that the government was liable to the plaintiffs for breach of contract. *Id.* at 843. The distinction recognized in *Winstar* between the general permissibility of legislative repeal, and the impermissibility of contract repudiation, also underlies the cases cited above.

Section 1708 does not by its terms qualify the ability of the Commission to enter into contracts. It is true, of course, that the Commission would approve the Reorganization Agreement by reason of a "decision or order." Once, however, the Commission enters into the Reorganization Agreement pursuant to such a decision or order, the Commission would be bound not by reason of the decision or order alone, but rather by reason of the independent binding force of the contract itself. In my opinion, section 1708 does not speak to or affect the binding force of the Reorganization Agreement as a contract. In addition, in this situation, as discussed below, such contract also will be subject to the Bankruptcy Court's order confirming the Joint Plan.

No cases applying section 1708 concern Commission contracts. *See, e.g.*, *City of Los Angeles v. Pub. Util. Comm'n*, 15 Cal. 3d 680 (1976) (concerning Commission's authority to approve tariffs for telephone rates); *In re United Parcel Serv., Inc.* [D. 97-04-049], 71 C.P.U.C.2d 714 (1997) (concerning Commission's authority to approve tariffs for intrastate small parcel delivery service rate increase). Those cases therefore support the understanding of section 1708 set forth above.

The distinction between overruling an order or decision and repudiating a contract is well grounded in California law. As noted above, a legislature or quasi-legislative body can ordinarily decide to amend or repeal a previously enacted or promulgated legal rule. In contrast, to permit a governmental entity simply to repudiate any contract to which it had previously agreed would undercut a third party's ability to contract with a governmental entity. Any governmental contract, from an agreement or consent decree settling a lawsuit to a construction contract could simply be rescinded. It is precisely for this reason that the courts have recognized this distinction. A construction of section 1708 limiting the Commission's power to enter into binding contracts, and in particular limiting the Commission's ability to enter into the

Reorganization Agreement, would find no support in the text of section 1708, the established principles that section 1708 codifies, or the case law interpreting section 1708. I therefore conclude that such a construction would be incorrect.

Bankruptcy Court Jurisdiction

Upon the effectiveness of the Joint Plan, pursuant to Article 10 of the Joint Plan, the Bankruptcy Court would retain jurisdiction to enforce all of the provisions of the Joint Plan, including without limitation, the Reorganization Agreement. The Reorganization Agreement itself provides for continuing jurisdiction of the Bankruptcy Court to enforce its provisions. Pursuant to section 1141(a) of the Bankruptcy Code, the provisions of the Joint Plan and the Reorganization Agreement would bind the Commission as a co-proponent of the Joint Plan. It is well settled that a proponent or co-proponent of a confirmed plan of reorganization is bound by the terms of such plan. *See Paul v. Monts*, 906 F.2d 1468, 1471 (10th Cir. 1990); *In re St. Mary Hospital*, 155 B.R. 345, 351 (Bankr. E.D. Pa. 1993); *Garsal Realty v. Troy Savings Bank*, 39 B.R. 991, 994 (Bankr. N.D.N.Y. 1984). In addition, the Order confirming the Joint Plan would contain express ordering provisions retaining for the Bankruptcy Court express authority to enforce provisions of the Joint Plan and the Reorganization Agreement.

Sovereign Immunity

I also conclude that the Commission can waive its sovereign immunity for the purpose of the Joint Plan and the Reorganization Agreement. "Under the Eleventh Amendment, a state is immune from suit under state or federal law by private parties in federal court absent a valid abrogation of that immunity or an express waiver by the state." *Mitchell v. Franchise Tax Board*, 209 F.3d 1111, 1115-1116 (9th Cir. 2000). The same immunity also applies to state agencies. *Fla. Dep't of State v. Treasure Salvors, Inc.*, 458 U.S. 670, 684 (1982); *see also In re Price*, 179 B.R. 209, 213 (E.D. Cal. 1995); *Cal. Indep. Sys. Operator Corp. v. Reliant Energy Servs., Inc.*, 181 F. Supp. 2d 1111, 1126 (E.D. Cal. 2001) (Department of Water Resources found to be arm of State and immune from suit in federal court). Thus, the Commission as a state agency possesses sovereign immunity under the Eleventh Amendment.

As a state agency, the Commission can assert or waive its Eleventh Amendment immunity on a case-by-case basis. *See Katz v. The Regents of the Univ. of Cal.*, 229 F.3d 831, 834 (9th Cir. 2000) (University's general counsel submitted a declaration waiving the State's sovereign immunity). The Ninth Circuit recently noted that "[s]overeign immunity is quasi-jurisdictional in nature. It may be forfeited where the state fails to assert it and therefore may be viewed as an affirmative defense. . . . A state generally waives its immunity when it 'voluntarily invokes [federal] jurisdiction or . . . makes a " ' clear declaration'" that it intends to submit itself to [federal] jurisdiction.'" *In re Bliemeister*, 296 F.3d 858, 861 (9th Cir. 2002). In addition, "[t]he Eleventh Amendment does not automatically destroy original jurisdiction. Rather, the Eleventh Amendment grants the State a legal power to assert a sovereign immunity defense should it choose to do so. The State can waive the defense. . . . This conclusion is consistent with prior Supreme Court case law." *Katz*, 229 F.3d at 835 (citing e.g. *Atascadero State*

*Hosp. v. Scanlon*, 473 U.S. 234, 241 (1985); *Patsy v. Board of Regents of Fla*, 457 U.S. 496 (1982); *Gardner v. New Jersey*, 329 U.S. 565 (1947)).[2]

No specific constitutional or statutory provision defines or limits the Commission's authority to waive its sovereign immunity under the Eleventh Amendment. Absent any prohibition, the Commission may assert or waive its sovereign immunity on a case-by-case basis in the performance of its regulatory duties.

Just and Reasonableness

Finally, with respect to the possible future assignment of DWR contracts to PG&E, I am not aware of any cases directly on point. However, I am aware of decisions in which the Commission found contracts negotiated and entered into by utilities to be prudent (i.e., just and reasonable) and not subject to future reasonableness review, absent a showing of misrepresentation or omission, gross negligence or imprudent contract administration on the part of the utility. See *Re Southern California Gas Company* (*"EAD Contract Decision"*) [D.92-11-052] 46 Cal.P.U.C.2d 444, 450 & 452 (Commission adopted the expedited application docket procedure for the review and approval of long-term natural gas contracts that were executed to prevent uneconomic bypass), as modified by *Re Southern California Gas Company* [D.94-09-070], 56 Cal.P.U.C.2d 500, 511 (1994) (permitting new GLT tariff to be filed under the EAD approval process); *see also, e.g. Re Pacific Gas and Electric Company* [D.93-07-051] 50 Cal.PU.C.2d 432, 433 (PG&E-Chevron U.S.A. Contract), rehearing denied in *Re Pacific Gas and Electric Company* [D.94-05-079], 54 Cal.P.U..C.2d 696 (1994); *Re Pacific Gas and Electric Company* [D.94-10-034, p. 6 (slip op.)] 56 Cal.P.U.C.2d 606] (1994) [text not published] (PG&E-Newark Group Industries contract). This type of procedure was intended to give the utilities certainty in entering into contracts to avoid uneconomic bypass. *See generally* 46 Cal.P.U.C.2d at 446-447. Thus, it appears, the Commission itself has recognized the need for regulatory certainty in these kinds of situations and there appear to be no cases in which the Commission has attempted to reverse itself as to the prudency of such previously approved contracts.

The essence of your question concerns whether the Commission could require PG&E to take assignment of certain DWR contracts after having found the contracts just and reasonable, and thereafter attempt to redetermine that the contracts were not just and reasonable while continuing to hold PG&E responsible for these contractual costs. In my opinion, it would be arbitrary and capricious for the Commission to take such a course of action, and if it did so, a court would reverse it for legal error.

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[2] The U.S. Supreme Court has interpreted California Constitution, Article III, Section 5 as a provision that authorizes the Legislature to waive the State's sovereign immunity. *Atascadero State Hosp. v. Scanlon*, 473 U.S. at 241.

In connection with the opinion, I have examined originals, or copies certified or otherwise identified to my satisfaction, of the following documents (collectively, the "Documents"):

(a) the Joint Plan

(b) the Reorganization Agreement

In addition, I have examined those other certificates, agreements and documents that I deemed relevant and necessary as a basis for my opinion. I have also relied upon the factual matters contained in the representations and warranties of the Commission made in the Documents.

* * *

Based upon the foregoing, and subject to the assumptions, exceptions and qualifications stated below, I am of the opinion that:

1. Assuming the Joint Plan becomes effective, the Commission has full power and authority to execute the Reorganization Agreement, and to perform its obligations under such Agreement; the Reorganization Agreement will have been duly executed and delivered by the Commission and will constitute the legal, valid and binding obligation of the Commission, enforceable against the Commission in accordance with its terms.

2. Assuming the Joint Plan becomes effective, the Commission will be bound to perform its obligations under the proposed Reorganization Agreement throughout the life of the securities expected to be offered under the Joint Plan.

3. The Commission may waive its right to sovereign immunity as contemplated by Section 5.3 of the Reorganization Agreement and Section 5.3 of the Reorganization Agreement constitutes an effective waiver of such right.

4. If the Commission were to require PG&E to take assignment of certain DWR contracts after finally determining that costs under those contracts were "just and reasonable", the Commission would act arbitrarily and capriciously if it subsequently changed this determination while continuing to hold PG&E responsible for these contractual costs, and it would be reversed in court for legal error.

5. If the Commission were to fail to perform its obligations under the Reorganization Agreement, the remedy of specific performance would be available.

This opinion is subject to the following assumptions, exceptions and qualifications:

I express no opinion as to: (i) the enforceability of forum selection clauses in the Federal courts; (ii) the enforceability of any provisions for indemnification of Persons for liability under Federal or state securities laws.

This opinion is limited to the laws of the State of California and the federal laws of the United States of America that, in each case, in my experience, are normally applicable to transactions of the type contemplated by the Documents (collectively, the "Covered Laws"). This opinion is rendered only with respect to the laws (including case law), and the rules, regulations and orders under those laws, which are currently in effect.

This opinion by me is solely for your benefit in connection with your review of the Joint Plan and the Reorganization Agreement and may not be circulated to, or relied upon by, any other person.

Very truly yours,

Gary ~~M.~~ Cohen
As General Counsel of the
California Public Utilities Commission

## CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document **"DIRECT TESTIMONY OF PAUL CLANON IN SUPPORT OF THE SETTLEMENT AGREEMENT SPONSORED BY PACIFIC GAS AND ELECTRIC COMPANY (PG&E), PG&E CORPORATION, AND THE PUBLIC UTILITIES COMMISSION (PUC) STAFF"** in **I.02-04-026.**

A copy has been e-mailed to all known parties of record who have provided e-mail addresses.

Executed in San Francisco, California, on the 25th day of July 2003.

Todd Edmister